B.B.A.

Third Year

Core Paper No. 12

BUSINESS LAW

BHARATHIAR UNIVERSITY

SCHOOL OF DISTANCE EDUCATION

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(Syllabus)

Core Paper-12 BUSINESS LAW

UNIT – I

The Indian contract Act, 1872: Contracts, meaning, essential elements, nature of contracts - Performance of contract. Discharge of contracts – Remedies for breach of contracts – Quasi contracts – contracts of Indemnity and guarantee – Bailment and Pledge – Law of Agency.

UNIT – II

The Sale of Goods Act, 1930 – contract of sale, essentials: Duties of buyers and sellers – Conditions and Warranties: Transfer of property- Performance of the contract of sale – Rights of an unpaid seller.

UNIT – III

The Negotiable Instrument Act, 1881: Negotiable instruments, parties to a negotiable instrument, material alteration.

The Indian Partnership Act, 1932: meaning and test of partnership; registration of firms; relations of partners; rights and duties; dissolution of partnership.

UNIT – IV

Law of Insurance: Contract of insurance; fundamental of principles; life insurance; fire insurance and marine insurance.

UNIT –V

The Companies Act, 1956; definition of a company, characteristics, kinds, incorporation of a company; Memorandum and Articles of association; Prospectus, Directors, Appointment, Powers and duties, Company meetings, Resolutions and Minutes.

RECOMMENDED BOOKS:

1. N.D.Kapoor - Elements of Mercantile Law
2. M.C.Shukla - Mercantile Law
3. D.F.Mulla - The Indian Contract Act

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UNIT-I

LESSON-1

LAW OF CONTRACT

CONTENTS

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AIMS AND OBJECTIVES

Business Law is a very important subject in that it equips the students to understand the various types of laws that are applicable to business. Unit I deals with the concept of Contracts, which is very vital for business.

This unit will help the students to understand:

- The significance of law in business
- What contracts are and the types of contracts
- The essential elements of valid contracts

INTRODUCTION

One should know the law to which he is subject because ignorance of law is no excuse. Mercantile law is not a separate branch of law. Basically, it is a part of civil law which deals with the rights and obligations of mercantile persons arising out of mercantile transactions in respect of mercantile property. It includes laws relating to various contracts, partnerships, companies, negotiable instruments, insurance, carriage of goods, arbitration etc.

1.1.1 INTRODUCTION

Law means a ‘set of rules’. It may be defined as the rules of conduct recognised and enforced by the state to control and regulate the conduct of people, to protect their property and contractual rights with a view to securing justice, peaceful living and social security.

The Law of Contract

The law of contract is that branch of law which determines the circumstances in which promises made by the parties to a contract shall be legally binding on them. Business law is of particular importance to people engaged in trade, commerce and industry as bulk of their business transactions are based on contracts.

1.1.2 THE INDIAN CONTRACT ACT, 1872

The law of contract is contained in the Indian Contract Act, 1872 which-

(a) Deals with the general principles of law governing all contracts, (Secs.1 to 75)
(b) Some special contracts only (Secs.124 to 238)

The first six chapters of the Act deal with the different stages in the formation of a contract, its essential elements, its performance or breach and the remedies for breach of contract. The remaining chapters deal with some of the special contracts, namely, Indemnity and Guarantee (Chapter VIII (Secs.124 to 147)), Bailment and Pledge (Chapter IX (Secs.148 to 181)) and Agency (Chapter X (Secs.182 to 238)).

Law of contract creates *jus in personam* as distinguished from *jus in rem*:

Jus in rem means a right against or in respect of a thing: *jus in personam* means a right against or in respect of a specific person. *Jus in rem* is available against the world at large; *jus in personam* is available only against particular persons.

Examples:

a. X owes a certain sum of money to Y. Y has a right to recover this amount from X. This right can be exercised only by Y and by none else against X. This right of Y is a *jus in personam.*
b. A is the owner of a house. He has a right to have quiet possession and enjoyment of that house against every member of the public. Similarly every member of the public is under an obligation not to disturb A's possession or enjoyment. This right of A is a *jus in rem.*

Meaning of Contract

According to Section 2(h) of the Indian Contract Act, 1872, "An agreement enforceable by law is a contract." In other words, an agreement which can be enforced in a court of law is known as a contract. A contract must have the following two elements.

a. An agreement, and
b. Its enforceability by law.

Sir William Anson defines a contract as, “a legally binding agreement between two or more persons by which rights are acquired by one or more to acts or forbearances (abstaining from doing something) on the part of the others”.

Pollock defines a contract as, “every agreement and promise enforceable at law is a contract”.

Agreement + Enforceability by law = Contract

Agreement

According to Section 2(e) of the Indian Contract Act, 1872, “Every promise and every set of promises forming the consideration for each other is an agreement.” A proposal when accepted becomes a promise.

Offer + Acceptance = Agreement

Enforceability of Agreement

An agreement is said to be enforceable by law if it creates some legal obligation. The parties to an agreement must be bound to perform their promises and in case of default by either of them, must intend to sue. Eg., in case of social or domestic agreements, the usual presumption that the parties do not intend to create legal relations.

Consensus ad idem

The essence of an agreement is the meeting of the minds of the parties in full and final agreement: there must, in fact, be *consensus ad idem*. This means that the parties to the agreement must have agreed about the subject-matter of the agreement in the same sense and at the same time. Unless there is consensus ad idem, there can be no contract.

Obligation

An agreement, to become a contract, must give rise to a legal obligation or duty. The term ‘obligation’ is defined as a legal tie which imposes upon a definite person or persons the necessity of doing or abstaining from doing a definite act or acts. It may relate to social or legal matters. An agreement which gives rise to a social obligation is not a contract. It must give rise to a legal obligation in order to become a contract.

Agreement is a very wide term

An agreement may be a social agreement or a legal agreement. If A invites B to a dinner and B accepts the invitation, it is a social agreement. A social agreement does not give rise to contractual obligations and is not enforceable in a Court of law. It is only those agreements which are enforceable in a Court of law which are contracts.

Examples:
(a) A invites his friend B to come and stay with him for a week. B accepts the invitation but when he comes to A, A cannot accommodate him as his wife had died the day before. B cannot claim any compensation from A as the agreement is a social one.

(b) A father promises to pay his son Rs. 500 every month as pocket allowance. Later he refuses to pay. The son cannot recover as it is a domestic agreement and there is no intention on the part of the parties to create legal relations.

To conclude: Contract = Agreement + Enforceability at law.

Thus all contracts are agreements but all agreements are not necessarily contracts.

1.1.3 ESSENTIAL ELEMENTS OF A VALID CONTRACT

According to Sec. 10, all agreements are contracts if they are made by the free consent of parties competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void. In order to become a contract, an agreement must have the following essential elements:

1. Minimum two persons:

There must be at least two persons for a contract to come into existence. One person to make the offer and the other person to accept it.

2. Offer and acceptance:

There must be two parties to an agreement, i.e., one party making the offer and other party accepting it. The terms of the offer must be definite and the acceptance of the offer must be absolute and unconditional. The acceptance must also be according to the mode prescribed and must be communicated to the offeror.

3. Intention to create legal relationship:

When the two parties enter into an agreement, their intention must be to create legal relationship between them. If there is no such intention on the part of the parties, there is no contract between them. Agreements of a social or domestic nature do not contemplate legal relationship, as such they are not contracts.

Example:

A husband promised to pay his wife a household allowance of £ 30 every month. Later the parties separated and the husband failed to pay the amount. The wife sued for the allowance. Held, agreements such as these were outside the realm of contract altogether [Balfour vs. Balfour, (l919) 2 K.B. 571].

In commercial and business agreements, the presumption is usually that the parties intended to create legal relations. But this presumption is rebuttable which means that it must be shown that the parties did not intend to be legally bound.

Examples:

(a) There was an agreement between R Company and C Company by means of which the former was appointed as the agent of the latter. One clause in the agreement was:"This agreement is not entered into ..... as a formal or legal agreement, and shall not be subject to legal jurisdiction in the law courts." Held, there was no binding contract as there was no intention to create legal relationship [Rose & Frank Co. vs. Crompton Bros., (1925) A.C. 445].

(b) In an agreement, a document contained a condition “that it shall not be attended by or give rise to any legal relationship, rights, duties, consequences whatsoever or be legally enforceable or be the subject of litigation, but all such arrangements, agreements and transactions are binding in honour only.” Held, the condition was valid and the agreement was not binding [Jones vs. Vernon's Pools. Ltd. (1938) 2 All E.R. 626].

4. Lawful consideration:

An agreement to be enforceable by law must be enforceable by consideration. ‘Consideration’ means an advantage or benefit moving from one party to the other. It is the essence of a bargain. In simple words, it means ‘something in return’. The agreement is legally enforceable only when both the parties give something and get something in return. A promise to do something, getting nothing in return is usually not enforceable by law. Consideration need not necessarily be in cash or kind. It may be an act or abstinence (abstaining from doing something) or promise to do or not to do something. It may be past, present or future. But it must be real and lawful. [Secs. 2 (d), 23 and 25).

5. Capacity of parties – competency:

The parties to the agreement must be capable of entering into a valid contract. Every person is competent to contract if he

(a) is of the age of majority,

(b) is of sound mind, and

(c) is not disqualified from contracting by any law to which he is subject (Secs. 11 and 12).

Flaw in capacity to contract may arise from minority, lunacy, idiocy, drunkenness, etc., and status. If a party suffers from any flaw in capacity, the agreement is not enforceable except in special cases.

6. Free and genuine consent:

It is essential to the creation of every contract that there must be free and genuine consent of the parties to the agreement. The consent of the parties is said to be free when they are of the same mind on all the material terms of the contract. The parties are said to be of the same mind when they agree about the subject-matter of the contract in the same sense and at the same time (Sec. 13). There is absence of free consent if the agreement is induced by coercion, undue influence, fraud, misrepresentation, etc. (Sec. 14).

7. Lawful object:

The object of the agreement must be lawful. In other words, it means that the object must not be

(a) ilIegal,

(b) immoral, or

(c) opposed to public policy (Sec. 23).

If an agreement suffers from any legal flaw, it would not be enforceable by law.

8. Agreement not declared void:

The agreement must not have been declared void by law in force in the country (Secs. 24 to 30 and 56).

9. Certainty and possibility of performance:

The agreement must be certain and not vague or indefinite (Sec. 29). If it is vague and it is not possible to ascertain its meaning, it cannot be enforced.

Examples:

(a) A agrees to sell to B "a hundred tons of oil". There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

(b) O agreed to purchase a motor van from S “on hire-purchase terms”. The hire-purchase price was to be paid over two years. Held, there was no contract as the terms were not certain about rate of interest and mode of payment. No precise meaning could be attributed to the words “on hire-purchase” since there was a wide variety of hire-purchase terms (Scammel vs. Ouston, (1941) A.C. 251].

The terms of the agreement must also be such as are capable of performance. Agreement to do an act impossible in itself cannot be enforced [Sec. 56 (1)]. For example, where A agrees with B to put life into B's dead wife, the agreement is void as it is impossible of performance.

10. Legal formalities:

A contract may be made by words spoken or written. As regards the legal effects, there is no difference between a contract in writing and a contract made by word of mouth. It is, however, in the interest of the parties that the contract should be in writing. There are some other formalities also which have to be complied with in order to make an agreement legally enforceable. In some cases, the document in which the contract is incorporated is to be stamped. In some other cases, a contract, besides being a written one, has to be registered. Thus where there is a statutory requirement that a contract should be made in writing or in the presence of witnesses or registered, the required statutory formalities must be complied with (Sec. 10, Para 2).

1.1.4 CLASSIFICATION OF CONTRACTS

Contracts may be classified according to their (1) validity, (2) formation, or (3) performance.

I. Classification according to validity

A contract is based on an agreement. An agreement becomes a contract when all the essential elements referred to above are present. In such a case, the contract is a valid contract. If one or more of these elements is/are missing, the contractt is either voidable, void, illegal or un-enforceable.

1. Voidable contract:

An agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other or others, is a voidable contract [Sec. 2(i)]. This happens when the element of free consent in a contract is missing. When the consent of a party to a contract is not free, i.e., it is caused by coercion, undue influence, misrepresentation or fraud, the contract is voidable at his option. The party whose consent is not free may either rescind (avoid or repudiate) the contract if he so desires, or elect to be bound by it. A voidable contract continues to be valid till it is avoided by the party entitled to do so.

Example: A promises to sell his car to B for Rs 2,00,000. His consent is obtained by use of force. The contract is voidable at the option of A. He may avoid the contract or elect to be bound by it.

A contract becomes voidable in the following two cases also:

i. When a person promises to do something for another person for a consideration but the other person prevents him from performing his promise, the contract becomes voidable at his option (Sec. 53).

Example: A and B contract that B shall execute certain work for A for Rs. 1,000. B is ready and willing to execute the work accordingly but A prevents him from doing so. The contract is voidable at the option of B and if he elects to rescind it, he is entitled to recover from A compensation for any loss which he has incurred by its non-performance.

ii. When a party to a contract promises to perform an obligation within a specified time, any failure on his part to perform his obligation within the specified time makes the contract voidable at the option of the promise (Sec. 55, Para 1).

When a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is promisor. If the party rescinding the contract has received benefit under the contract from another party to such contract he shall restore such benefit, so far as may be, to the person from whom it was received (Sec. 64). The party rightfully rescinding the contract is also entitled to compensation for any damage which he has sustained through the non-fulfilment of the contract (Sec. 65).

2. Void agreement and void contract:

(i) Void agreement:

An agreement not enforceable by law is said to be void [Sec. 2 (g)]. A void agreement does not create any legal rights or obligations. It is a nullity and is destitute of legal effects altogether. It is void ab initio. i.e., from the very beginning as, for example, an agreement with a minor or an agreement without consideration.

(ii) Void contract:

A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable [Sec. 2 (j)]. A contract, when originally entered into, may be valid and binding on the parties, e.g., a contract to import goods from a foreign country. It may subsequently become void, e.g., when a war breaks out between the importing country and the exporting country.

It is illogical to talk of a void contract originally entered into, for what is supposed to be a contract is no contract at all.

(iii) Illegal agreement:

An illegal agreement is one which transgresses some rule of basic public policy or which is criminal in nature or which is immoral. Such an agreement is a nullity and has much wider import than a void contract. All Illegal agreements are void but all void agreements or contracts are not necessarily illegal. An illegal agreement is not only void as between the immediate parties, but has this further effect that even the collateral transactions to it become tainted with illegality. A collateral transaction is one which is subsidiary, incidental or auxiliary to the principal or original contract.

Example: B borrows Rs. 5,000 from A and enters into a contract with an alien to import prohibited goods. A knows of the purpose of the loan. The transaction between B and A is collateral to the main agreement. It is illegal since the main agreement is illegal.

3. Unenforceable contract:

An unenforceable contract is one which cannot be enforced in a Court of law because of some technical defect such as absence of writing or where the remedy has been barred by lapse of time. The contract may be carried out by the parties concerned; but in the event of breach or repudiation of such a contract, the aggrieved party will not be entitled to the legal remedies.

II. Classification according to formation

A contract may be (a) made in writing or by word of mouth, or (b) inferred from the conduct of the parties or the circumstances of the case. These are the modes of formation of a contract.

Contracts may be classified according to the mode of their formation as follows:

1. Express contract:

If the terms of a contract are expressly agreed upon (whether by words spoken or written) at the time of formation of the contract, the contract is said to be an express contract. Where the offer or acceptance of any promise is made in words, the promise is said to be express (Sec. 9). An express promise results in an express contract.

2. **Implied contract:**

An implied contract is one which is inferred from the acts or conduct of the parties or course of dealings between them. It is not the result of any express promises by the parties but of their particular acts. It may also result from a continuing course of conduct of the parties. Where the proposal or acceptance of any promise is made otherwise than in words, the promise is said to be implied (Sec. 9). An implied promise results in an implied contract.

Examples:

a. there an implied contract when A –

i. takes a cup of tea in a restaurant,
ii. gets in to a public bus,
iii. obtains a ticket form an automatic weighing machine , or
iv. lifts B's luggage to be carried out of the railway station

b. A fire broke out in Ps farm. He called upon the Upton Fire Brigade to put out the fire which the latter did. P's farm did not come under the free service zone although he believed to be so. Held, he was liable to pay for the service rendered as the service was rendered on an implied promise to pay [Upton Rural District Council vs. Powell (1942) All E.R. 220].

3. Quasi-contract:

Strictly speaking, a quasi-contract is not a contract at all. A contract is intentionally entered into by the parties. A quasi-contract, on the other hand, is created by law. It resembles a contract in that a legal obligation is imposed on a party who is required to perform it. It rests on the ground of equity that "a person shall not be allowed to enrich himself unjustly at the expense of another."

Example:

X, a tradesman, leaves goods at Cs house by mistake. C treats the goods as his own. C is bound to pay for the goods.

4. E-Commerce contract:

An E-commerce contract is one which is entered into between two parties via Internet. In Internet, different individuals or companies create networks which are linked to numerous other networks. This expands the area of operation in commercial transactions for any person.

III. Classification according to performance

To the extent to which the contracts have been performed, these may be classified as -

1. Executed contract:

'Executed' means that which is done. An executed contract is one in which both the parties have performed their respective obligations.

Example:

A agrees to paint a picture for B for Rs. 1,000. When A paints the picture and B pays the price, i.e., when both the parties perform their obligations, the contract is said to be executed.

In some cases, even though a contract may appear to be completed at once, its effects may still continue. Thus when a person buys a bun containing a stone and subsequently breaks one of his teeth, he has a right to recover damages from the seller [Chaproniere vs. Mason, (1905) 21 T.L.R 633].

2. Executory contract:

'Executory' means that which remains to be carried into effect. An executor contract is one in which both the parties have yet to perform their obligations. Thus, in the example, the contract is executory if A has not yet painted the picture and B has not paid the price. Similarly, if A agrees to engage B as his servant from the next month, the contract is executory.

A contract may sometimes be partly executed and partly executory . Thus, if B has paid the price to A and A has not yet painted the picture, the contract is executed, as to B and executory as to A .

Another classification of contracts according to the performance is as follows:

1. Unilateral or one-sided contract:

A unilateral or one-sided contract is one in which only one party has to fulfil his obligation at the time of the formation of the contract, the other party having fulfilled his obligation at the time of the contract or before the contract comes into existence. Such contracts are also known as contracts with executed consideration.

Example:

A permits a railway coolie to carry his luggage and place it in a carriage. A contract comes into existence as soon as the luggage is placed in the carriage. But by that time the coolie has already performed his obligation. Now only A has to fulfil his obligation, i.e., pay the reasonable charges to the coolie

2. Bilateral contract:

A bilateral contract is one in which the obligations on the part of both the parties to the contract are outstanding at the time of the formation of the contract. In this sense, bilateral contracts are similar to executory contracts and are also known as contracts with executory consideration.

1.1.5 CONTINGENT CONTRACTS

A contract may be-

i. an absolute contract or

ii. a contingent contract.

An ‘absolute contract’ is one in which the promisor binds himself to performance in any event without any conditions.

‘Contingent’ means that which is dependent on something else.

A contingent contract' is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen (Sec. 31). Where, for example, goods are sent on approval, the contract is a contingent contract depending on the act of the buyer to accept or reject the goods.

Examples:

a. A contracts to pay Rs. 10,000 if B's house is burnt. This is a contingent contract.

b. A agrees to sell a certain piece of land to B, in case he succeeds in his litigation concerning that land. This is a contingent contract.

There are three essential characteristics of a contingent contract:

i. Its performance depends upon the happening or non-happening in future of some event. It is this dependence on a future event which distinguishes a contingent contract from other contracts.

ii. The event must be uncertain. If the event is bound to happen, and the contract has got to be performed in any case it is not a contingent contract.

iii. The event must be collateral, i.e., incidental to the contract.

Contracts of insurance, indemnity and guarantee are the commonest instances of a contingent contract.

Rules regarding Contingent contracts:

i. Contingent contracts dependent on the happening of an uncertain future event cannot be enforced until the event has happened. If the event becomes impossible, such contracts become void (Sec. 32).

ii. Where a contingent contract is to be performed if a particular event does not happen, its performance can be enforced when the happening of that event becomes impossible (Sec. 33).

iii. If a contract is contingent upon how a person will act at unspecified time, the- event shall be considered to become impossible when such person does anything which renders it impossible that he should so act within any definite time, or otherwise than under futher contingencies (Sec. 34).

iv. Contingent contracts to do or not to do anything, if a specified uncertain event happens within a fixed time, become void if the event does not happen or its happening becomes impossible before the expiry of that time.

v. Contingent agreements to do or not do anything, if an impossible event happens, are void, whether or not the fact is known to the parties (Sec.36).

Wagering agreements or Wager (Sec.30)

A wager is an agreement between two parties by which one promises to pay money or money's worth on the happening of some uncertain event in consideration of the other party's promise to pay if the event does not happen. Thus, if A and B enter into an agreement that A shall pay B Rs.1,000 if it rains on Monday, and that B shall pay A the

same amount if it does not rain, it is a wagering agreement. The event may be uncertain either because it is to happen in future or if it has already happened, the parties are uncertain and express opposite views.

Essentials of a wagering agreement:

1. Promise to pay money or money's worth:

The wagering agreement must contain a promise to pay money or money's worth.

2. Uncertain event:

The promise must be conditional on an event happening or not happening. A wager generally contemplates a future event, but it may also relate to a past event provided the parties are not aware of its result or the time of its happening.

3. Each party must stand to win or lose:

Upon the determination of the contemplated event, each party should stand to win or lose. An agreement is not a wager if either of the parties may win but cannot lose or may lose but cannot win.

4. No control over the event:

Neither party should have control over the happening of the event one way or the other. If one of the parties has the event in his own hands, the transaction lacks essential ingredients of a wager.

5. No other interest in the event:

Lastly, neither party should have any interest in the happening or non-happening of the event other than the sum or stake he will win or lose. Thus an agreement is not a wager if the party to whom money is promised on the occurrence of an event has an 'interest' in its non-occurrence.

Difference between a wagering agreement and a contingent contract:

i. A wagering agreement consists of reciprocal promises whereas a contingent contract may not contain reciprocal promises.
ii. A wagering agreement is essentially of a contingent nature a contingent contract may not be of a wagering nature.
iii. A wagering agreement is void whereas a contingent contract is valid.
iv. In a wagering agreement, the parties have no other interest in the subject-matter of the agreement except the winning or losing of the amount of the wager. In other words, a wagering agreement is a game of chance. This is not so in case of a contingent contract.
v. In a wagering agreement the future event is the sole determining factor while in a contingent contract the future event is only collateral.

Check your progress - 1

Define contract. Enumerate the essentials of a valid contract.

LESSON-2

OFFER AND ACCEPTANCE

CONTENTS

1.2.1 Valid Offer
1.2.2 Legal rules of a valid offer
1.2.3 Meaning of Cross Offer
1.2.4 Meaning of Standing Offer
1.2.5 Acceptance
1.2.6 Legal rules as to Acceptance
1.2.7 Communication of Offer and Acceptance
1.2.8 Revocation of Offer and Acceptance
Check your progress: 2

1.2.1 VALID OFFER

Meaning of Offer [Section 2(a)]

An offer is the starting point in the making of an agreement. An offer is also called 'proposal'. According to Section 2(a) of The Indian Contract Act, 1872, "A person is said to have made the proposal when he signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that offer to such act or abstinence."

Thus, an offer involves the following essential elements:

i. It must be made by one person to another person. In other words, there can be no proposal by a person to himself.

   Example: X says to Y that he wants to sell his car to himself for Rs 1 lakh. There is no proposal because there can be no proposal by a person to himself.

ii. It must be an expression of readiness or willingness to do (i.e. a positive act) or to abstain from doing something (i.e. a negative act).

   Example : X offers to sell his car to Y for Rs 1 lakh. It is a positive act on the part of X. Example : X offers not to file a suit against Y if Y pays X the outstanding amount of Rs 1,00,000. It is a negative act on the part of X.

iii. It must be made with a view to obtain the consent of that other person to proposed act or abstinence.

Example: X jokingly says to Y ”I am ready to sell my car for Rs 1,000.” Y, knowingly that X is not serious in making the offer, says “I accept your offer.” In this case, X’s offer was not the real offer as he did not make it with a view to obtain the consent of Y.

Meaning of “Offerer” (or ‘Promisor’), Offeree (or Promisee):

The person making the proposal is called the offerer or proposer. The person to whom the proposal is made is called the 'offeree' or 'proposee'.

Example X says to Y, “I want to sell my car to you for Rs 1 lakh.” Here, ‘to sell car’ is an offer or proposal. X who has made the offer is called offeror or promisor. Y to whom the offer has been made is called the offeree or proposee.

How to Make an Offer

An offer can be made by any act which has the effect of communicating it to another person. An offer may, either be an ‘express offer’ or ‘implied offer’.

1. Express Offer:
An express offer is one which is made by words spoken or written.

Example I: X says to Y, “Will you purchase my car for Rs 1,00,000?”

Example II: X writes to Y in a letter, “I want to sell my house for Rs 2,00,000”

Example III: X advertises in a newspaper that I will pay Rs 1,000 to anyone who traces my missing nephew.

2. Implied Offer:
An implied offer is one which is made otherwise than in words. In other words, it is inferred from the conduct of the person or the circumstances of the particular case.

Example I: A transport company runs buses on different routes to carry passengers. It is an implied offer by the transport company to carry passengers for a certain fare.
Example II: A bid at an auction is an implied offer to buy.

3. Specific Offer:
A specific offer is one which is made to a definite person or particular group of persons. A specific offer can be accepted only by that definite person or that particular group of persons to whom it has been made.

Example: X offers to buy car from Y for Rs 1.0 lakh. This offer is a specific offer which has been made to a definite person Y. No person other than Y can accept this offer. [Boulton vs. Jones].

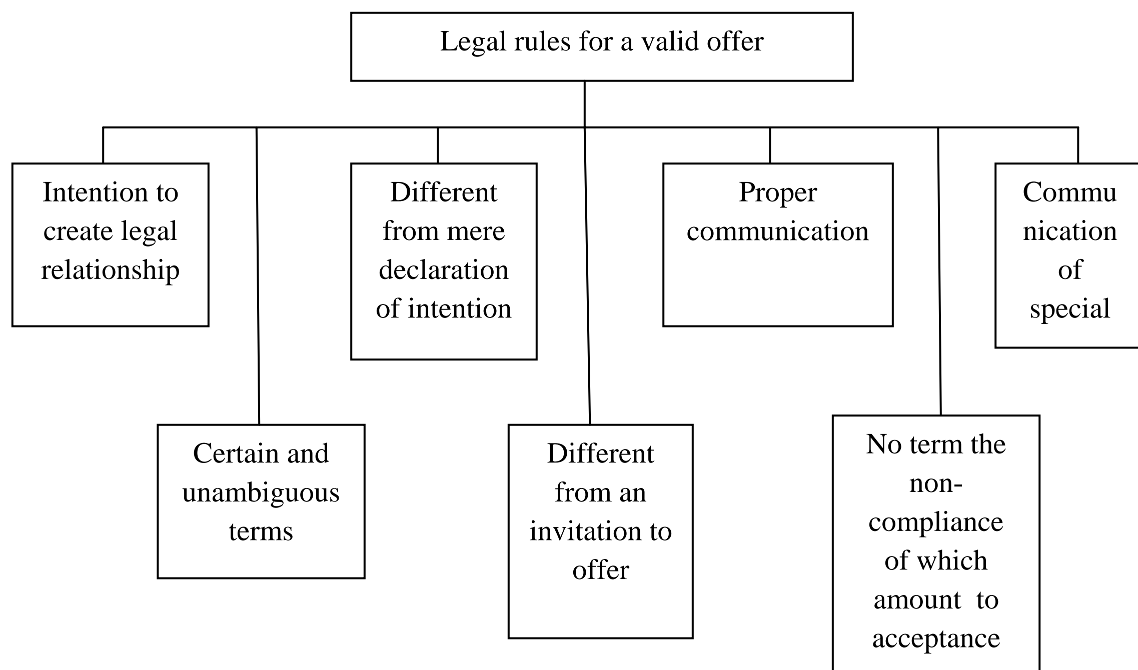
Similarly an offer made to a company is an offer to a group of persons and hence a specific offer.

4. General Offer:
A general offer is one which is not made to a definite person, but to the world at large or public in general. A general offer can be accepted by any person by fulfilling the terms of the offer. In case of general offer, the contract is made with person who having the knowledge of the offer comes forward and acts according to the conditions of the offer.
Example I: X advertised in the newspaper that he would pay Rs 5,000 to anyone who traces his missing boy. Y, who knew about the reward traced that boy and sent a telegram to X that he had found his son. It was held that X was entitled to receive the amount of reward.
[Harbhajan Lal vs. Harcharan Lal (AIR All 539)].

Example II: Carbolic Smoke Ball Co. advertised in the newspaper that it would pay Rs 1,000 to anyone who contracts influenza after using the smoke ball of the company according the printed instructions. Mrs. Carlil uses the smoke ball according to the printed directions but subsequently contracted influenza. On a suit for the reward she was held entitled to recover the same because she had accepted the offer by fulfilling the terms of the offer. [Carlil vs. Carbolic Smoke Ball Co.]

1.2.2 LEGAL RULES OF A VALID OFFER

An offer to be valid must fulfil the following conditions:



1. **Intention to Create Legal Relationship**: An offer must intend to create legal relations. An offer must be such that when accepted, it will create legal relationship among the parties.

The question whether or not the parties have intention to create legal relationship can be answered with reference to type and terms of agreement and the circumstances under which the agreement is made.

2. **Certain and Unambiguous Terms**: The terms of the offer must be certain and unambiguous and not vague. If the terms of the offer are vague, no contract can be entered into because it is not clear as to what exactly the parties intended to do.

Example I : X offers to sell to Y"a 100 tons of oil." If X is a dealer in coconut oil and mustard oil, his offer is not certain because it is not clear that he wants to sell coconut oil or mustard oil. But if X is a dealer in coconut oil only, it is clear that he wants to sell coconut oil. Hence, the offer is certain.

Example II: X offers to sell to Y his car for Rs 1,00,000 or Rs 1,50,000. Here X's offer is not certain because it is not clear which of the two prices was to be given by Y.

Note: If the terms of the offer are capable of being made certain, the offer is not regarded as vague. For example, X offers to sell to Y "a 1 00 tons of coconut oil." Here, the offer cannot be said to be uncertain on the ground that it is not clear what price is to be given for oil because in such a case if such an offer is accepted by Y, Y has to give only a reasonable price.

3. **Different from a Mere Declaration of Intention**: The offer must be distinguished from a mere declaration of intention. Such statement or declaration merely indicates that an offer will be made or invited in future.

Example I: A father wrote to his would be son-in-law that his daughter would have a share of what he left after the death of his wife. It was held that the letter was a mere statement of intention and not an offer. [Farine vs. Fickar]

Example II: X, a broker of Mumbai wrote to Y, a merchant of Ghaziabad stating the terms, on which he is willing to do business. It was held that the letter was a mere statement of intention and not an offer. [Devidatt vs. Shriram]

Example III: A notice that the goods stated in the notice will be sold by tender does not amount to an offer to sell. [Spencer vs. Harding]

Example IV: An auctioneer advertised in a newspaper that a sale of office furniture will be held on a particular day. Mr X, with the intention to buy furniture came from a distant place for the auction but the auction was cancelled. It was held that Mr X cannot file a suit against the auctioneer for his loss of time and expenses because the advertisement was merely a declaration of intention to hold auction and not an offer to sell. [Harris vs. N. Nickerson]

4. **Different from an Invitation to Offer:** An offer must be distinguished from an invitation to offer. In case of an invitation to offer, the person making an invitation invites others to make an offer to him. It is prelude to an offer inviting negotiations or preliminary discussions.

Example I: Goods were displayed in the shop for sale with price tags attached on each article and self service system was there. One customer selected the goods. It was held that the display of goods was only an intention to offer and the selection of the goods was an offer by the customer to buy and the contract was made when the cashier accepted the offer to buy and received the price. [Pharmaceutical Society of Great Britain vs. Boots Cash Chemists Ltd.]

Example II: A prospectus issued by a company for subscription of its shares and debentures is only an invitation to general public to make an offer to buy the shares/debentures which may or may not be accepted by the company.

Similarly, an advertisement inviting quotations of lowest price in response to an enquiry amounts to invitation to offer but not an offer capable of acceptance, e.g. in Harvey vs. Facie (1893), X sent a telegram to Y asking "Will you sell us Bumper Hall Penn? Telegraph Lowest Cash Price." Y replied through a telegram "Lowest Price for Bumper Hall Penn £900: X replied telegraphically stating "We agree to buy Bumper Hall Penn for £900 asked by you". Held, the quotation of price by Y was a mere invitation to offer. Consent of X to purchase the estate for £900 was an offer.

5. **Communication:** An offer must be communicated to the person to whom it is made. An offer is complete only when it is communicated to the offeree. One can accept the offer only when he knows about it. Thus, an offer accepted without its knowledge does not confer any legal rights on the acceptor.

Example I: G sent his servant L to trace his lost nephew. When the servant had left, G announced a reward of Rs 500 to anyone who traces the missing boy. L found the boy and brought him home. When L came to know about reward, he filed a suit against G to recover the reward. It was held that L was not entitled to the reward because he did not know about the reward when he found the missing boy. [Lalman Shukla vs. Gauri Dutt]

Example II: S offered a reward to anyone who traces his lost dog. F brought the dog without knowledge of the offer of reward. It was held that F was not entitled to the reward because F cannot be said to have accepted the offer which he did not know. [Filch vs. Snedakar].

6. **No Term the Non-compliance of which Amounts to Acceptance**: The offer must not contain a term the non-compliance of which would amount to acceptance. It means that while making the offer, the offerer cannot say that if offer is not accepted before a certain date, it will be presumed to have been accepted.

Example: X writes a letter to Y. I offer to sell my car for Rs 1,00,000. If I do not receive your reply by Friday next, I shall assume that you have accepted the offer. Here if Y does not reply, it does not mean that he has accepted the offer.

7. **Communication of Special Terms or Standard Form Contracts**: The special terms of the offer must also be communicated along with the offer. If the special terms of the offer are not communicated, the offeree will not be bound by terms. The question of special terms arises generally in case of standard form contracts. Standard contracts are made with big companies such as insurance companies, railways, shipping companies, banking companies, hotel companies, cleaning companies. Since such companies are in position to exploit the weakness of general public by including certain terms in the contract which may limit their liabilities, it is provided that the special terms of the offer must be brought to notice of general public.

Example I: X purchased a steamer ticket for travelling from Dablin to White Haven and on the back of the ticket, certain conditions were printed one of which excluded the liability of the company for loss, injury or delay to the passengers or his luggage. X never looked at the back of the ticket and there was nothing to draw his attention to the conditions printed on the back. His luggage was lost due to the negligence of the servants of the shipping company. It held that X was entitled to claim compensation for the loss of his luggage in spite of the exemption clause because there was no indication on the face of the ticket to draw his attention to the special terms printed on the back of the ticket. [Handerson vs. Stevenson]

Notes:

i. In case the special conditions are printed in a language which the offeree does not understand, it is the offeree’s duty to ask for the translation of the condition before accepting the offer and if he does not ask, it shall be presumed that he knows them and he will be bound by them.

ii. The special terms and conditions must be brought to the knowledge of the offeree before the contract is concluded and not afterwards. A subsequent communication will not bind the acceptor unless he himself agrees thereto. For example, Mr X and Mrs X hired a room in hotel for a week. When they entered the room, they found a notice on the wall disclaiming the owner's liability for damages, loss or theft of articles. Some of their items were stolen. It was held that owner was liable because the notice was not a part of the contract as it came to the knowledge of the customer after the contract was entered into. [Olley vs. Marlborough Court Ltd.]

iii. The special terms and conditions must be reasonable. What is reasonable is a question of facts. If terms and conditions are unreasonable, the other party will not be bound by them. For example, if a dry cleaner limits his liability to 25% of the market price of the article in case of loss, the customer will not be bound by this condition because it means that the dry cleaner can purchase garments at 25% of the market price. In Lily White Drycleaners vs. Munnuswamy AIR 1966 (Mad.), the receipt issued by the drycleaner stated that the drycleaner would be liable only to the extent of 10 times the dry-cleaning charges in the event of any damage to the clothes. Held, such a clause was unreasonable and opposed to public policy, and therefore, couldn’t bind the parties.

1.2.3 MEANING OF CROSS OFFERS

Two offers which are similar in all respects made by two parties to each other, in ignorance of each other's offer are known as "cross offers". Cross offers do not amount to acceptance of one's offer by the other. Hence, no contract is entered into on cross offers.

Example: X of Agra sends a letter by post to Y of Delhi offering to sell his car for Rs 1 lakh. The letter is posted on 1st January and the same day, Y of Delhi sends a letter by post to X of Agra offering to buy X's car for Rs 1 lakh. These two letters cross each other. Y's letter is merely an offer and not the acceptance of X's letter. Here, both the parties are making offer and no party has accepted the offer. Therefore, no contract has been entered into. If they want to enter into a contract, at least one of them must send his acceptance to the offer made by the other.

1.2.4 MEANING OF STANDING OFFER

An offer of a continuous nature is known as "standing offer". A standing offer is in the nature of a tender. It is the same thing as an invitation to an offer. A contract is said to have been entered into only when an order is placed on the basis of the tender.

Example: X Ltd. requires a large quantity of certain goods during the 12 months period and gives an advertisement inviting tender in the leading newspaper. Z submitted the tender to supply those goods at a specific rate. Z's tender is accepted or approved. Now, Z's tender becomes a standing offer. Each order given by X Ltd. will be an acceptance of the offer.

1.2.5 ACCEPTANCE

Meaning of Acceptance

Acceptance means giving consent to the offer. It is an expression by the offeree of his willingness to be bound by the terms of the offer. According to Section 2(b) of the Indian Contract Act, 1872, "A proposal is said to be accepted when the person to whom the proposal is made signifies his assent thereto. A proposal when accepted becomes a promise."

In other words, an acceptance is the consent given to offer.

Example: X offers to sell his car to Y for Rs 1,00,000. Y agrees to buy the car for Rs 1,00,000. Y's act is an acceptance of X's offer.

Who Can Accept?

In general, an offer can be accepted only by the person or persons to whom it is made. The specific answer to this question can be given with reference to type of offer as under:

i. In Case of Specific Offer: An offer made to a definite person or particular group of persons (called specific offer) can be accepted only by that definite person or that particular group of persons to whom it has been made and none else.

Example: X sold his business to Y but this fact was not known to an old customer Z. Z placed an order for certain goods to X by name. Y supplied those goods to Z. It was held that there was no contract between Y and Z because Z never made any offer to Y. [Boulton vs. Jones]

ii. In Case of General Offer: An offer made to the world at large or public in general (called general offer) can be accepted by any person having knowledge of the offer by fulfilling the terms of the offer.

Example: A Company advertised that it would pay $100 to anyone who contracts influenza after using the smoke balls of the company according to the printed directions. Mrs Carlil used the smoke balls according to the printed directions but subsequently she contracted influenza. She filed a suit for the reward. It was held that she was entitled to recover the reward because she had accepted the offer by complying with the terms of the offer. [Carli vs. Carbolic Smoke Ball Company]

How to Make Acceptance?

Like an offer, an acceptance may also be either an “implied acceptance” or “express acceptance”.

a. Express Acceptance: An express acceptance is one which is made by words spoken or written.

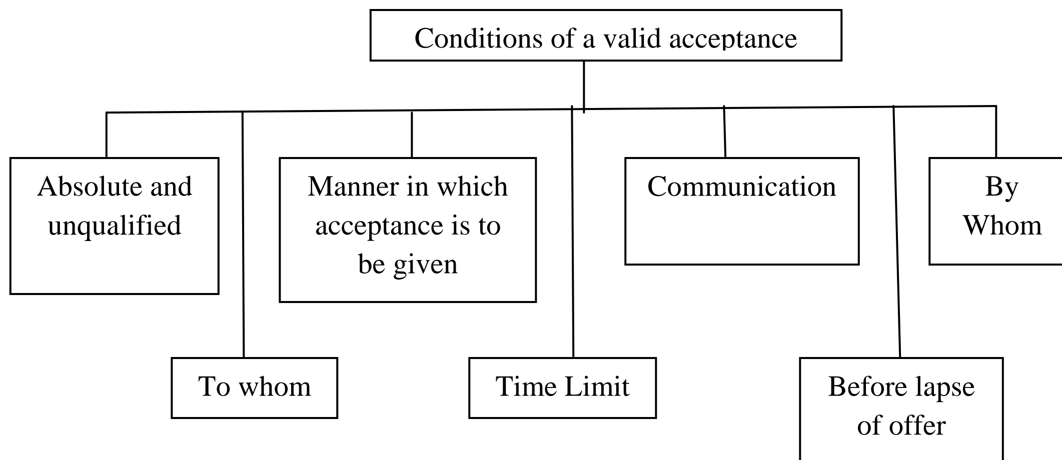
Example: X says to Y, “Will you purchase my car for Rs 1,00,000?”. Then Y says, “I am ready to purchase your car for Rs 1,00,000.”

b. Implied Acceptance: An implied acceptance is one which is made otherwise than in words. In other words, it is inferred from the conduct of the person or the circumstances of the particular case.

Example: A transport company runs buses on different routes to carry passengers. X, a passenger boards the bus. X’s act is an implied acceptance by X and he is bound to pay the fare.

1.2.6 LEGAL RULES FOR A VALID ACCEPTANCE

An acceptance to be valid must fulfil certain conditions which are as follows:



1. **Absolute and Unqualified**: According to Section 7(1) of the Indian Contract Act, 1872, "In order to convert a proposal into a promise, the acceptance must be absolute and unqualified." It means that an offer must be accepted as it is without any reservation, variation or condition. A qualified and conditional acceptance amounts to marking of a counter offer which puts an end to the original offer and it cannot be revived by subsequent acceptance.

Example I: X offered to sell his car for Rs 1,00,000 to Y. B agreed to buy it for Rs 90,000. V's act is a counter offer and not an acceptance of X's offer. Now, if Y accepts the original offer to buy the car for Rs 1,00,000, X will not be bound to sell the car because V's counter offer has put an end to the original offer. [Nihal Chand vs. Amar Nath]
Example II: X offered to sell two plots of land to Y at a certain price. Y accepted the offer for one plot. It was held that the acceptance was not valid because it was not for the whole of the offer. [Bhawan vs. Sadula]

2. **Manner**: According to Section 7(2) of the Indian Contract Act, 1872, the acceptance of an offer must be given in the following manner.

(a) If the proposal does not prescribe the manner in which it is to be accepted.	The offer must be accepted in some usual and reasonable manner.
(b) If the proposal prescribes the manner in which it is to be accepted.	The offer must be accepted in the prescribed manner.

The consequences of not accepting the offer in the prescribed manner: If the offer is not accepted in the prescribed manner, the offerer may approve or reject such acceptance. If the offerer wants to reject it, he must inform the acceptor within a reasonable time that he

is not bound by acceptance because it is not in the prescribed manner. If he does not do so within a reasonable time the presumption will be that he doesn't mind the offer being accepted in a different mode and will be bound by such acceptance.

Example: X of Agra sends a letter by post to Y of Delhi offering to sell his car for Rs 1,00,000 and also writes "send your acceptance by telegram." Y sends his acceptance by an ordinary letter. X can reject such acceptance on the ground that it was not accepted in the prescribed manner. But if he does not inform Y within the reasonable time, he shall be deemed to have accepted such acceptance and a valid contract will be formed between X and Y.

3. **Communication:** The acceptance must be signified (i.e. indicated or declared). In other words, the acceptance is complete only when it has been communicated to the offerer. A mere mental determination to accept is no acceptance in the eyes of law unless there is some external manifestation of that determination by words or conduct.

Example: X offered to supply coal to a Railway Company. The manager of the company accepted the offer and put it in the drawer of his table and forgot all about it. It was held that no contract was made because acceptance was not communicated. (Brogden vs. Metropolitan Railway Co.]

Note:

In case of acceptance made by post, the proposer becomes bound by the acceptance as soon as the properly addressed and stamped letter of acceptance is duly posted even if such letter of acceptance is lost or delayed in post.

4. **By Whom:** Acceptance must be communicated by the offeree himself or by a person who has the authority to accept. In other words, if acceptance is communicated by an unauthorised person, it will not give rise to legal relations.

Example: P applied for the post of a headmaster in a school. The managing committee passed a resolution approving P to the post but this decision was not communicated to P. But one member of the managing committee in his individual capacity and without any authority informed P about the decision. Subsequently, the managing committee cancelled its resolution and appointed someone else. P filed a suit for breach of contract. It was held that P's suit was not maintainable because there was no communication of acceptance as he was not informed about his appointment by some authorised person. [Powell vs. Lee]

Note:
The communication of acceptance is not necessary in case of unilateral contracts where the offerer prescribed a particular mode of acceptance. In such cases, it is sufficient if that prescribed mode is followed as in case of Carlil vs. Smoke Ball Co. and Har Bhajan Lal v. Harcharn Lal.

5. **To Whom**: Acceptance must be communicated to the offerer himself. In other words, if acceptance is communicated to an unauthorised person, it will not give rise to legal relations.

Example: F offered by a letter to buy his nephew's horse for $30 saying "If I hear no more about him, I shall consider the horse mine." The nephew sent no reply at all but told B his auctioneer, not to sell that particular horse as he intended to sell that horse to F. B sold the horse by mistake. It was held that F will not succeed because his nephew had not communicated acceptance to him. [Felthouse vs. Bindley]

6. **Time Limit:** The acceptance must be given within the time prescribed (if any) or within a reasonable time (if no time is prescribed). What is reasonable time depends upon the facts and circumstances of the case.

Example: An offer to buy shares of a company was made in June but the acceptance was communicated in November, it was held that the offerer was not bound by the acceptance because the acceptance was not given within a reasonable time. [Ramsgate Victoria Hotel Co. vs. Montefiore]

7. **Before Lapse of Offer:** The acceptance must be given before the offer lapses or is withdrawn. In other words, if an acceptance is made after the lapse or withdrawal of the offer, it will not give rise to legal relations.

Example: X offered by a letter to sell his car for Rs 1,00,000. Subsequently, X withdrew his offer by a telegram which was duly received by Y. After the receipt of telegram, Y sent his acceptance to X. In this case, the acceptance is invalid because it was made after the effective withdrawal of the offer.

1.2.7 COMMUNICATION OF OFFER AND ACCEPTANCE

The communication of offer and acceptance must complete so as to bind the concerned parties because as soon as the communication is complete the parties loose the right of withdrawal or revocation. The legal provisions relating to the communication of offer and acceptance are as under:

i. **Communication of Offer**: The communication of offer is complete when it comes to the knowledge of the person to whom it is made. In case an offer is made by post, its communication will complete when the letter containing the offer reaches the offeree.

Example: X of Agra sends a letter by post to Y of Delhi offering to sell his car for Rs 1,00,000. The letter is posted on 1st January and this letter reaches on 7th January. The communication of the offer is complete on 7th January.

Note:

An offer accepted without its complete communication does not bind the offeror.

Example: In case of Lalman vs. Gauri Duff, G sent his servant L to trace his lost nephew. When the servant had left, G announced a reward to anyone who traces the boy. L found the boy and brought him home. When L came to know of the reward, he claimed the reward. It was held that L was not entitled to the reward because he did not know about the offer when he found the missing boy.

ii. **Communication of Acceptance**: The communication of acceptance is complete at different times for the proposer and acceptor. The rules regarding the Communication of acceptance are as under:

The communication of acceptance is complete ...	*When does the communication of acceptance complete...*
i. As against the proposer	When it is put in a course of transmission to him, so as to be out of the power of the acceptor. In case of acceptance made by post, the proposer becomes bound by the acceptance as soon as the properly addressed and stamped letter of acceptance is duly posted even if such letter of acceptance is lost or delayed in post.
ii. As against the acceptor	When it comes to the knowledge of the proposer. In case of acceptance made by post, the acceptor becomes bound by the acceptance only when the letter of acceptance is actually received by proposer.

Note:

The time gap between the date on which the letter of acceptance is posted and the date on which the letter of acceptance is received by the proposer, can be utilized by the acceptor to withdraw his acceptance by a speedier mode of communication so that the revocation notice reaches the proposer before the letter of acceptance.

Example: X of Agra sends a letter by post to Y of Delhi offering to sell his car for Rs 1,00,000. The letter is posted on 1st January and this letter reaches Y on 7th January. Y sends his acceptance by post on 10th January but X receives this letter of acceptance on

15th, January. In this case the legal position relating to the communication of offer and acceptance is as under:

Communication	*When does the communication complete*	*Reason*
i.Communication of offer	7th Jan.	The letter containing the offer reaches the offeree on 7th Jan.
ii.Communication of acceptance as against the proposer	10th Jan.	The letter of acceptance is posted on 10th Jan.
iii. Communication of acceptance as against the acceptor	15th Jan.	The letter of acceptance is received by the proposer on 15th Jan.

After posting the letter of acceptance on 10th January, Y can withdraw his acceptance by a speedier mode of communication so that the revocation notice reaches the proposer before the letter of acceptance.

Contracts over telephone/telex/fax:
A contract by telephone/telex/fax is treated on the same principle as an oral agreement made between two parties when they are face to face with each other. In such cases, the contract will complete only when the acceptance is received by the proposer and not when it is transmitted by the acceptor. Therefore, the acceptor must ensure that his acceptance is properly received by the proposer.

Example: X made an offer to Y over telephone. While Y was conveying his acceptance, the line went dead and X could not hear anything. In this case, there was no contract at that moment.

Note:
In case of contracts over telephone, telex or fax, the question of revocation (i.e. withdrawal of acceptance) does not arise because there is instantaneous communication of the offer and its acceptance (i.e. the offer is made and accepted at the same time).

1.2.8 REVOCATION OF OFFER AND ACCEPTANCE

Meaning of Revocation:

The term ‘revocation’ means ‘taking back’ or ‘withdrawal’.

Time Limit within which Offer can be Revoked [Section 5]:

According to Section 5 of the Indian Contract Act, a proposal may be revoked at any time before the communication of its acceptance is complete as against the proposer, but not afterwards. We know that communication of acceptance is complete as against the proposer when a properly addressed and stamped letter of acceptance is duly posted by the acceptor. Hence, an offer can be revoked at any time before the letter of acceptance is duly posted by the acceptor. Thus, the proposer may revoke his offer by a speedier mode of communication which will reach before the letter of acceptance is posted by the acceptor.

Example: X of Agra offers by a letter dated 1st January sent by post to sell his car to Y of Delhi for Rs. 1,00,000. Y accepts the offer on 7th January at 1 p.m. by letter sent by post. Here, X may revoke his offer at any time before 1 p.m. on 7th Jan. but not afterwards.

Notes:

i. Revocation must always be expressed.
ii. Revocation must move from the offerer himself or a duly authorised agent.
iii. Notice of revocation of a general offer must be given through the same channel by which the original offer was made.
iv. Offer cannot be revoked even if the letter of acceptance is lost or delayed in transit.

Time Limit within which Acceptance can be Revoked [Section 5]:

According to Section 5 of the Indian Contract Act, "An acceptance may be revoked at any time before the communication of the acceptance is complete as against the acceptor, but not afterwards." We know that communication of acceptance is complete as against the acceptor when the letter of acceptance is actually received by the proposer. Hence, an acceptance can be revoked at any time before the letter of acceptance is actually received by the proposer. Thus an acceptor may revoke his acceptance by a speedier mode of communication which will reach before the letter of acceptance is received by the proposer.

Example: X of Agra offers by a letter dated 1st January sent by post to sell his car to Y of Delhi for Rs 1,00,000. Y accepts the offer on 7th Jan. at 1 p.m. by a letter sent by post. X receives the letter of acceptance on 15th Jan. at 3 p.m. Here, Y may revoke his acceptance at any time before 3 p.m. on 15th Jan. but not afterwards.

Acceptance is to Offer what a Lighted Match is to a Train of Gunpowder:

The position relating to revocation of proposal and acceptance has been described by Anson in the following words,
"Acceptance is to offer what a lighted match is to a train of gunpowder. It produces something which cannot be recalled or undone."

This statement primarily holds good under English law.

Here, gunpowder = offer and lighted match = acceptance

When a lighted match is shown to a train of gunpowder, it explodes and something happens which cannot be undone. Similarly, an offer once accepted cannot be revoked. But so long a lighted match is not shown, the gunpowder remains inert and can be removed, similarly an offer can be revoked before it is accepted.

Similarly, once acceptance is given it cannot be revoked. But under Indian Contract Act, acceptance can be revoked by resorting to quicker means of communication so that the offerer learns about it before acceptance. Thus, the above statement doesn't hold in relation to revocation of acceptance under Indian law.

Simultaneous Delivery of Letter of Acceptance and the Telegram containing Revocation of Acceptance:

In case the letter of acceptance and the telegram containing revocation of acceptance are delivered to the proposer at the same time, the formation of contract depends upon the fact which one is read first by the offerer. The contract shall be said to have been formed if the letter of acceptance is read first but shall not be said to have been formed if the telegram containing revocation of acceptance is read first. Generally, it is presumed that a man of ordinary prudence will first read the telegram. Hence the revocation will be quite effective.

No Revocation in case of Contract over Telephone or Telex of Fax:

In case of contracts over telephone or telex or fax, the question of revocation does not arise because there is instantaneous communication of the offer and its acceptance (i.e. the offer is made and accepted at the same time).

Communication of Revocation [Section 4]:

The communication of revocation is complete at different times for person who makes it and the person to whom it is made. The rules regarding the communication of revocation are as under:

The communication of revocation is complete ...	*When does the communication of revocation complete ...*
(i) As against the person who makes it	When it is put in a course of transmission to the person to whom it is made so as to be out of the power of the person who makes it.
(ii) As against the person to whom it is made	When it comes to his knowledge.

Example: X proposes by letter to sell his car to Y for Rs 1,00,000. Y accepts X's proposal by a letter sent by post. If X revokes his proposal by telegram, the revocation of offer is complete as against X when the telegram is dispatched and it is complete as against Y when Y receives the telegram. If Y revokes his acceptance by telegram, the revocation of acceptance is complete against Y when the telegram is despatched and as against X when it reaches him.

Lapse of an Offer:

An offer must be accepted before it lapses (i.e. comes to an end). An offer may come to end in any of the following ways:

1. **By Revocation**: An offer lapses if the offerer revokes the offer before its acceptance by the offeree. According to Section 5 of the Indian Contract Act, a proposal may be revoked at any time before the communication of acceptance is complete as against the proposer but not afterwards.

Example I: X of Agra offers by a letter dated 1st January sent by post to sell his car to Y of Delhi for Rs 1,00,000. Y accepts the offer on 7th January at 1 p.m. by a letter sent by post. Here, X may revoke his offer at any time before 1 p.m. on 7th Jan. but not afterwards.

Example II: At an auction sale, the highest bidder can revoke his offer to buy before the fall of the hammer.

2. **By Lapse of Time:** An offer lapses if it is not accepted within the fixed time (if any prescribed in the offer) or within reasonable time (if no time is prescribed in the offer).

Example: An offer to buy shares of a Company was made in June but the acceptance was communicated in November. It was held that offer to buy shares had lapsed because it was not accepted within a reasonable time. [Ramsgate Victoria Hotel Co. vs. Montefiore]

3. **By Death or Insanity of the Offeror or Offeree**: An offer lapses by the death or insanity of the offeror if the fact of his death or insanity comes to the knowledge of the acceptor before he makes his acceptance. In other words, if the offer is accepted in ignorance of the death or insanity of the offeror, there will be a valid contract. It may be noted that in English law the death of the offeror terminates the offer even if acceptance is made in ignorance of the death.

An offer also comes to an end by the death or insanity of the offeree if the offeree dies or becomes insane before accepting the offer because an offer can be accepted only by the offeree and not by any other person.

4. **By Failure to Accept Condition Precedent**: An offer lapses if it is accepted without fulfilling the conditions of the offer.

Example: X offered to sell his car to Y for Rs 1,00,000 subject to the condition that Y should pay an advance of Rs 20,000 before a certain date. Y accepted the offer but did not send an advance of Rs 20,000. In this case, the offer has lapsed because the advance was not paid.

5. **By Counter Offer**: An offer lapses if the counter offer is made because a counter offer amounts to rejection of the original offer. Counter means making a fresh offer instead of accepting the original offer.

Example: X offered to sell his car to Y for Rs 1,00,000. Y said that he would buy it for Rs 90,000. X refused to sell for Rs 90,000. Subsequently, Y offered to buy the car for Rs 1,00,000. Here, V's offer to buy for Rs 90,000 is a counter offer which terminates the original offer. V's second offer to buy for Rs 1,00,000 is a fresh offer and not an acceptance of the original offer. [Hyde vs. Wrench)

6. **By not Accepting in the Prescribed Mode or Usual Mode:** An offer if it is not accepted in the specific manner (if any, prescribed in the offer) or in some usual and reasonable manner (if no manner has been prescribed in the offer).

Example: X offered to sell his car to Y for Rs 1,00,000 and wrote to Y "Send your acceptance by telegram." Y sent acceptance by an ordinary letter. X can reject such acceptance.

7. **By Rejection of Offer by Offeree**: An offer lapses if it is rejected by the offeree. An offer is said to be rejected if the offeree expressly rejects it or accepts it subject to certain conditions. It may be noted that once an offer is rejected, it cannot be revived subsequently.

8. **By Subsequent illegality or Destruction of Subject Matter of the Offer:** An offer lapses if it becomes illegal or the subject matter is destroyed before its acceptance by offeree.

Example I: X of Delhi offered supply of 100 tons of sugar to Y at Mumbai on a certain date. Before this offer is accepted by Y, the Central Government issued an order prohibiting the inter-state movement of sugar. Here, X's offer has come to an end.

Example II: X of Delhi offered to sell his car to Y of Agra for Rs 1,00,000. Before the offer is accepted by Y, the car is destroyed by fire. Here X's offer has come to an end.

Check your progress – 2

Explain Offer, Acceptance and Revocation

LESSON-3
CAPACITIES OF PARTIES

CONTENTS

1.3.1 Position of agreements by minor
1.3.2 Position of persons of unsound mind
1.3.3 Persons disqualified by law
Check your progress: 3

According to Section 11 of the Indian Contract Act, 1872, "Every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind, and is not disqualified from contracting by any law to which he is subject." Thus, all the three tests (viz. age, soundness, disqualification) must be applied to determine whether a person is competent to contract or not.

Position of agreements with a Minor:

A minor is a person who has not attained majority. According to Section 3 of the Indian Majority Act, 1875, a person is deemed to have attained majority as under:

(a) Where a guardian of a minor's person or property is appointed under the Guardian and Wards Act, 1890	On completion of 21 years
(b) Where minor's property has passed under the superintendence of the court of wards	On completion of 21 years
(c) In other cases	On completion of 18 years

1.3.1 POSITION OF AGREEMENTS BY MINOR

The law protects minor's rights because they are not mature and may not possess the capacity to judge what is good and what is bad for them. The position of agreements with or by a minor may be summarised as under:

1. **Validity:** An agreement with a minor is void ab-initio [Leading case Law Mohiri Bibee vs. Dhannodas Ghosh]

   D, a minor borrowed a sum from M by executing a mortgage of his property in favour of M. Subsequently, D sued for setting aside the mortgage. The Privy Council held that Sections 10 and 11 of the Indian Contract Act make the minor's agreement void and therefore the mortgage was not valid. M prayed for refund of the amount by the minor. It was held that the money advanced to minor cannot be recovered because minor's agreement was void.

2. **No Estoppel**: A minor is not estopped from setting up the plea of minority.
   He may plead infancy to escape from being liable. In G. Bhimappa Meti vs. Balangowda Bhimangowda; the Bombay High Court held that "Where an infant represents fraudulently or otherwise that he is of age and thereby induces another to enter into a contract with him, he in an action founded on the contract, is not estopped from setting up infancy."

3. **In case of fraudulent representation of age by minor:** According to Sections 30 and 33 of the Specific Relief Act, 1963, in case of a fraudulent misrepresentation of his age by the minor inducing the other party to enter into a contract, the court may award compensation to the other party. The Lahore High Court in Khan Cui vs. Lakha Singh held that where the contract is set aside, the status quo ante should be restored and the court may direct the minor on equitable grounds to restore the money or property to the other party if the money or property could be traced.

4. **Ratification on attaining the age of majority**: An agreement with a minor cannot be ratified even after he attains majority. Ratification relates back to the date of the making of the agreement and therefore an agreement which was then void cannot be made valid by subsequent ratification. In Indran Ramaswamy vs. Anthaoppa, a person on attaining majority, gave a promissory note in satisfaction of one executed by him for money borrowed when he was a minor. It was held that the claim under the promissory note could not be enforced because there was no consideration.

5. **Validity of minor's agreement jointly with a major person**: The agreements made by a minor jointly with a major person are void vis-a-vis the minor but can be enforced against the major person who has jointly promised to perform.

6. **Minor as a partner**: A minor cannot become a partner in a partnership firm.

   However, according to Section 30 of Indian Partnership Act 1932, with the consent of all the partners for the time being be admitted to the benefits of partnership. In other words, he can share the profits without incurring any personal liability.

7. **Minor as an agent:** A minor can act as an agent and bind his principal by his acts without incurring any personal liability.

8. **Minor as a shareholder or member of a company:** A minor can become a shareholder or member of a Company if
(a) the shares are fully paid up and
(b) the articles of association do not prohibit so.

9. **Minor as an insolvent**: A minor cannot be declared insolvent because he is not competent to contract.

10. **Contract for the benefit of a minor:** A minor can be a promisee. In Raghva Chariar vs. Srinivasa, the Madras High Court held that a mortgage executed in favour of a minor who has advanced the mortgage money is enforceable by him or by any other person on his behalf. Similarly, in case of sale of goods by a minor, he is entitled to recover the price from the buyer. Thus, he may be a promisee but not promisor on a promissory note or a drawer but not drawee on a bill of exchange.

11. **Contract by minor's guardian:** The contracts entered into on behalf of a minor by his guardian or manager of his estate can be enforced by or against the minor if the contract
(a) is within the scope of the authority of guardian or manager, and
(b) is for the benefit of the minor. [Subramanyam vs. Subba Rao].
It may also be noted that his guardian cannot enter into a valid contract for purchase of the immovable property for his/her service.

12. **Contract for supply of necessaries:** A person who has supplied the necessaries to a minor or to those who are dependent on him is entitled to be reimbursed from the property of such minor. [Section 68].
Meaning of necessaries: The term necessaries includes articles required to maintain a particular person in the state, degree and station in life in which he is. According to Section 2 of English Sale of Goods Act, the necessaries mean the goods which are suitable to the condition in life of a minor and to his actual requirement at the time of sale and delivery. In India, food, clothing, shelter, education arid marriage of a female has been held to be necessaries. Section 68 covers the reimbursement for the supply of such items or loans for the same.

Example:
In case of Nash vs. Inman, a minor bought eleven fancy coats from N for his own use. It was held that eleven coats at a time cannot be a necessity.

Section 68 also covers the rendering of necessary services to a minor.
For example, the lending of money to a minor for the purpose of defending him in prosecution is deemed to be a service rendered to the minor.

'*Claim against property and not against person*': A claim for the payment of necessaries supplied can be made against the minor's property and not against the minor personally. In other words, a minor cannot be asked to expend labour in exchange.

Liability of minor's guardian: The parent or guardian of a minor cannot be held liable unless those goods/services are supplied/rendered to a minor as the agent of the parent or guardian.

13. **Minor's liability in Tort:** A minor may be held liable in Tort (civil wrong).
    But if in the course of doing what he is entitled to do under the contract, he is found guilty of negligence, he cannot be made liable on tort if he is not liable on the contract, e.g. in Burnard vs. Huggis, a minor hired a horse promising not to jump it. He lent the horse to his friend who used the horse against the instructions and this led to the death of the horse. The minor was held liable on Tort. But in another case a horse was hired for riding. The horse was injured due to over-riding. The minor could not be held liable since the injury resulted from negligence in the course of what he was entitled to do under the contract. Since he was not liable on the contract himself, he could not be held liable in tort too. (Jennings vs. Randal].

1.3.2 POSITION OF PERSONS OF UNSOUND MIND

Who is a Person of Unsound Mind?

According to Section 12 of the Indian Contract Act, "A person is said to be of sound mind for the purpose of making a contract, if at the time when he makes it, is capable-

(a) to understand the terms of the contract,

(b) to form a rational judgment as to its effect upon his interests."

Thus, if a person is not capable of both, he is said to have suffered from unsoundness of mind. The examples of persons having an unsound mind include idiots, lunatics and drunken persons. A person who is so mentally deficient by birth as to be incapable of ordinary reasoning or rational conduct is said to be an "idiot". A person affected by lunacy is said to be "lunatic'. A person can become lunatic at any stage of his life.

Position of a Person who is Usually of Unsound Mind but Occasionally of Sound Mind:

According to Section 12, "A person who is usually of unsound mind but occasionally of sound mind may make a contract when he is of sound mind."

Example: A patient in a lunatic asylum who is at intervals of sound mind may contract during those lucid intervals.

Position of a Person who is Usually of Sound Mind but Occasionally of Unsound Mind:

According to Section 12, "A person who is usually of sound mind but occasionally of unsound mind may not make a contract when he is of unsound mind."

Example: A sane man who is so drunk that he cannot understand the terms of a contract or form a rational judgment as to its effect on his interest, cannot enter into contract whilst such drunkenness lasts.

Burden of Proof:

The rules regarding the burden of proof are summarised as under:

Case	*The burden of proof lies on ...*
i. Where a person is usually of sound mind	The burden of proving that he was of unsound mind at the time of contract lies on the person who challenges the validity of contract
ii. Where a person is usually of unsound mind	The burden of proving that he was of sound mind at the time of contract lies on the person who affirms it
iii. In case of drunkenness or delirium from fever or other causes	The burden of proving that he was delirious from fever or was so drunk at the time of contract, lies on the person who challenges the validity of the contract

Position of Agreements with Persons of Unsound Mind:

Persons of unsound mind	*Capacity to enter into contract*
1.Lunatic (i.e. a person who is mentally deranged due to some mental strain or other personal experience but who has some lucid intervals of sound mind) (a) While he is of unsound mind (b) While he is of sound mind	He cannot enter into any contract. Any agreement entered into by him during this period is altogether void and he cannot be held liable thereon. He can enter into a valid contract and he is liable for such contracts.
2.Idiots (i.e. a person who is permanently of unsound mind)	He cannot enter into any contract. Any agreement entered into by him is altogether void and he is not liable thereon.
3.Drunken person (i.e. a sane person who is delirious from fever or who is so drunk that he cannot understand the terms of a contract or form a rational judgment as to its effect on his interest)	He cannot contract while such delirium or drunkenness lasts.

1.3.3 PERSONS DISQUALIFIED BY LAW

Besides minors and persons of unsound mind, there are others who are disqualified from contracting under the provision of some other laws.

1. Alien Enemy:

An alien is a person who is the citizen of a foreign country. An alien may either an alien friend or an alien enemy.
An alien whose country is at peace with the Republic of India is called as alien friend. He has usually the full contractual capacity.

An alien whose country is at war with the Republic of India is called an alien enemy. His contractual capacity can be summarised as under:

Position of contracts entered during the war	An alien enemy can neither enter into any contract nor can be sued in an Indian Court except by licence from the Central Governnment.
Position of contracts entered into before the war a. If such contracts are against the public policy or are such that may benefit the enemy b. If such contracts are not against public policy	a. Such contracts stand dissolved b. Such contracts are merely suspended for the duration of the war and revived after the war is over unless they have already become time barred under the Law of Limitation Act.

Example:
X, an Indian, carries on a business in Pakistan. He enters into a contract with Y who carries on business in India. Immediately after the formation of the contract, a war broke out between India and Pakistan. In this case, X becomes an alien enemy though he is Indian and the contract between X and Y (if not against the public policy) will be suspended for the duration of the war and revived after the war is over.

2. Foreign Sovereigns and Ambassadors:
They can enter into contracts and enforce those contracts in our courts but they cannot be sued in our courts without the sanction of the Central Government unless they choose to submit themselves to the jurisdictions of our Courts.

Notes:

(i) An ex-king can be sued in our Courts.

(ii) Where a foreign sovereign etc. enter into a contract through an agent residing in India, the agent shall be held liable on the contract.

3. Convicts:

A person is called a convict during his period of sentence. His contractual capacity is summarised as under:

1. During the period of sentence	He cannot enter into any contract.
2. After the expiration of the period of sentence or when he is on parole.	He can enter into a contract. He can sue on a contract.

4. Company under the Companies Act or Statutory Corporation under the Special Act of Parliament:

The contractual capacity of the company and the statutory corporation is summarised as under:

1. In case of a Company	Its contractual capacity is determined by the 'object clause' of its Memorandum of Association.
2. In case of Statutory Corporation	Its contractual capacity is determined by the statute creating it.

Any act done in excess of the power given is ultra vires (i.e. beyond power) and hence void.

5. Insolvents :

When a person's debts exceed his assets, he is adjudged insolvent and his property stands vested in the Official Receiver or Official Assignee appointed by the Court.

Such person-

(i) cannot enter into contracts relating to his property,

(ii) cannot sue,

(iii) cannot be sued

Note : When the insolvent is discharged, the aforesaid disqualification is removed.

Check your progress – 3:

Discuss ‘capacity to contract’.

LESSON-4
CONSIDERATION

CONTENTS

1.4.1 Essential elements of a valid consideration
1.4.2 Stranger to a contract
1.4.3 Contract without consideration
Check your progress: 4

Consideration is one of the essential elements of a valid contract.

The term 'consideration' means something in return, i.e. quid-pro-quo. What is 'something' has been explained by Justice Lush J. in a leading English case Currie vs. Misa as under:

"A valuable consideration in the sense of the law, may consist either in some right, interest, profit or benefit accruing to one party or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other."

Thus, consideration must result in a benefit to the promisor, and a detriment or loss to the promisee or a detriment to both. Section 2(d) of the Indian Contract Act, 1872 defines consideration as under:

"When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or abstain from doing something, such act or abstinence or promise is called a consideration for the promise."

Example I: X promises to deliver his good to Y and Y promises to pay Rs 1,000 on delivery. In this case, the consideration for each of these promises is as under:

For X's promise - Y's promise to pay Rs 1,000 on delivery
For Y's promise - X's promise to deliver his goods

Example II: X owes Y Rs 10,000. Y promises X not to file a suit against him for one year on X's agreeing to pay him Rs 500 more. In this case, the consideration for each of the promise is as under:

For X's promise - Forbearance on the part of Y to file a suit
For Y's promise - X's promise to pay Rs 500 more

1.4.1 ESSENTIAL ELEMENTS OF VALID CONSIDERATION

On the basis of definition of consideration as per Section 2(d), the essential elements of valid consideration are:

1. It must be given only at the Desire of the Promisor:

An act constituting consideration must have been done at the desire or request of the promisor. Thus, an act done at the desire of a third party or without the desire of the promisor cannot constitute a valid consideration.

Example I: A's son is lost and B goes in search for him. Can B claim remuneration from

A. (a) if B does this act voluntarily

(b) if B does this act at the request of A

(c) if B does this act at the request of C?

(a) if B does this act voluntarily?
B cannot claim remuneration from A because he has not done at A's request.

(b) if B does this act at the request of A?
B can claim remuneration from A because he has done at A's request.

(c) if B does this act at the request of C?
B cannot claim remuneration from A because he has not done at A's request.

Example II: X spent Rs 1,00,000 on the construction of shops at the request of the collector of the District. In consideration of this Y a shopkeeper promised to pay some money to X. It was held that this agreement was void being without consideration because X had constructed the shops at the request of collector and not at the desire of Y. [Ourga Prasad vs. Baldeo]

2. It may Move from any Person:

An act constituting consideration may be done by the promisee himself or any other person (i.e. stranger to consideration). Thus, it is immaterial who furnishes the consideration and therefore, may move from the promisee or any other person.

3. It may be Past or Present or Future:

The consideration may be past, present or future.

Past Consideration	The consideration which has already moved before the formation of agreement. Example: X renders some service to Y at Ys request in the month of May. In June, Y promises to pay X Rs 1,000 for his past services. Past services amount to past consideration. X can recover Rs 1,000 from Y.
Present Consideration	The consideration which moves simultaneously with the promise is called present consideration. Example: In case of cash sale, promise to pay the price and promise to deliver the goods are performed simultaneously.
Future Consideration	The consideration which is to be moved after the formation of agreement is called future consideration. Example: X promises to deliver certain goods to Y after 10 days and Y promises to pay after 10 days from the date of delivery.

4. It must be of Some Value:

The consideration need not be adequate to the promise but it must be of some value in the eye of the law. It is understood in the sense of something in return and that something can be anything, adequate or grossly inadequate. According to Explanation 2 of Section 25, an agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate; but the inadequacy of the consideration may be taken into account by the Court in determining the question whether the consent of the promisor was freely given.

Example: A agrees to sell a horse worth Rs 1,000 for Rs 10. A denies that his consent to the agreement was freely given. The inadequacy of the consideration is a fact which the Court should taken into account in considering whether or not A's consent was freely given.

5. It must be Real and not Illusory:

The consideration must be real and not illusory.

Example I: X engages Y for doing a certain work and promises to pay reasonable remuneration. This promise is not enforceable because the consideration is uncertain.

Example II: X promises to put life into Y's dead wife and Y promises to pay Rs 1,00,000. This agreement is void because consideration is physically impossible to perform.

6. Something other than the Promisor's Existing Obligation:
The act constituting consideration must be something which the promisor is not already bound to do because a promise to do what a promisor is already bound to do adds nothing to the existing obligation.

Example I: X promises Y, his advocate, to pay an additional sum if the suit was successful. The suit was declared in favour of X but X refused to pay additional sum. It was held that Y could not recover additional sum because the promise to pay additional sum was void for want of consideration as Y was already bound to render his best services under the original agreement. [Ramchandra Chintamana vs. Kalu Raju]

Example II: X had received summons to appear before a court of law as witness on behalf of Y who promised to pay some money for his trouble. It was held that the promises to pay money were void for want of consideration because X was under a legal duty to appear as witness before court of law. [Collins vs. Godefroa]

7. Lawful:

The consideration must neither be unlawful nor opposed to public policy.

Example I: X promises Y to pay Rs 1,000 to beat Z, Y beats Z and claims Rs 1,000 from X, X refuses to pay. Y cannot recover because the agreement is void on the ground of unlawful consideration.

Example II: X promises Y to obtain an employment in the public service and Y promises to pay Rs 1,000 to X. The agreement is void on the ground of unlawful consideration.

1.4.2 STRANGER TO A CONTRACT

Though a stranger to consideration can sue because the consideration can be furnished or supplied by any person whether he is the promisee or not, but a stranger to a contract cannot sue because of the absence of privity of contract. (i.e., relationship subsisting between the parties to a contract).

Example I: X owes Y Rs 1,00,000 and sells his property to Z. Z promises to payoff X's debt to Y. Z fails to pay. Y cannot sue Z because he is a stranger to a contract.

Example II: X bought tyres from Dunlop Rubber Co. and sold them to Y, a sub-dealer who agreed with X not to sell below Dunlop's list price and to pay to Dunlop Co. Rs 150 as damages on every tyre he undersold. Y sold two tyres at less than the list price and

there upon, Dunlop Co. sued him for the breach. It was held that the Dunlop Co. could not maintain the suit because it was a stranger to the contract. [Dunlop P. Tyre Co. Ltd. vs. Self ridge & Co. Ltd.]

Exceptions

The rule that a stranger to a contract cannot sue, is subject to the following exceptions:

a. **In case of Trusts**:

The beneficiary (i.e. the person for whose benefit the trust has been created) may enforce the contract.

Example I: X transferred certain properties to be held by Y for the benefit of Z. Z can enforce the agreement even though he is not a party to the agreement. [M.K. Rapai vs. John]

Example II: X sent an insured parcel to Y. On loss of such parcel, Y sued the post office. It was held that Y was entitled to sue though he was stranger to the contract because on receipt of such article, the post office becomes a trustee for the addressee. [Amir Ullah vs. Central Govt.]

Example III: X, the father of a minor daughter D, and Y, the father of a minor son S, entered into an agreement of marriage for D and S on the condition that after the marriage, Y would pay his daughter-in-law D, Rs 500 as kharch-e-paan daan (betel box money). After the marriage took place, X died. On Y’s refusal to pay the agreed amount to D, the Court held that D was entitled to recover the amount as a beneficiary of trust even if she was a stranger to the contract between X and Y. [Khwaja Mohd. vs. Hussaini Begum (1910) 37.1A 152]

b. In Case of Family Settlement:

The person for whose benefit the provision is made under family arrangements may enforce the contract.

Example: A provision of marriage expenses of a female member was made in a Joint Hindu Family. On partition, the female member sued for such expenses. It was held that she was entitled to sue. [Rakhmanbai vs. Govindj

c. Acknowledgement:

The person who becomes an agent of third party by acknowledgement or otherwise, can be sued by such third party.

Example: X receives Rs 1,000 from Y for paying the same to Z. X acknowledges this receipt to Z. Z can recover the amount from X because X will be regarded as Z’s agent. [Surjan vs. Nanaf].

d. Assignment of a Contract:

Where a benefit under a contract has been assigned, the assignee can enforce the contract subject to all equities between the original parties to the contract e.g. the assignee of an insurance policy.

1.4.3 CONTRACTS WITHOUT CONSIDERATION

General Rule:

According to Section 10, consideration is one of the essential elements of a contract. According to Section 25, an agreement made without consideration is void. For example, X promises to pay Rs 5,000 to his girlfriend Y. This promise cannot be enforced by Y because she is not giving anything to X for this promise.

In Abdul Aziz vs. Mazum Ali, a promise to donate Rs 500 towards construction of a mosque was held unenforceable as it was a gratuitous promise lacking consideration. But gratuitous promise shall be enforceable by law if the promisee on the faith of such promise suffered a liability as suffering of detriment forms a valid consideration [Kedarnath vs. Gorie Mohd.]

Exceptions to the General Rule – ‘No Consideration, No Contract’

The following are the exceptions to the general rule No Consideration, No Contract:

i. Agreements Made on Account of Natural Love and Affection [Section 25(1)]: Such agreement made without consideration is valid if:

a. it is expressed in writing,

b. is registered under the law,

c. it is made on account of love and affection, and

d. it is between parties standing in a near relation to each other.

Note: Nearness of relation by itself does not necessarily import love and affection.

Example I: A Hindu husband by a registered document promised to pay his wife Rs 1,000 per month as her pin-pocket money. This agreement is valid.

Example II: A Hindu husband by a registered document, after referring to quarrels and disagreements between himself and his wife, promised to pay his wife Rs 1,000 p.m. for her maintenance. It was held that this agreement was void because there was no natural love and affection. (Rajlakhi Devi vs. Bhoot Nath Mookherjee]

ii. Promise to Compensate [Section 25(2)]:

Such promise made without consideration is valid if:

a. it is a promise to compensate (wholly or in part); and

b. the person who is to be compensated has already done something voluntarily or has done something which the promisor was legally bound to do.

Example I: X finds Y's purse and gives it to him. Y promises to give Rs 500 to X. This is a valid contract even though the consideration did not move at the desire of Y, the promisor.

Example II: X, a neighbour helped putting down the fire in Y's house. Afterwards, Y promised X to give Rs 1,000. This is a valid contract even though the consideration did not move at the desire of the promisor.

Example III: X, supported Y's infant son. Y promised to pay X's expenses in so doing. This is a valid contract. Here, X has done that act which Y was legally bound to do.

iii. Promise to Pay Time Barred Debt [Section 25(3):

Such promise without consideration is valid if:

a. it is made in writing,

b. it is signed by the debtor or his agent, and

c. it relates to a debt which could not be enforced by a creditor because of limitation.

Note: According to the law of limitation, a debt which remains unpaid or unclaimed for a period of 3 years, becomes a time barred debt which is legally not recoverable. But a promissory note issued in personal capacity by the wife of a debtor to pay his time barred debt of her husband is not enforceable [Pestonjee vs. Bai Meharbai].

iv. Completed Gifts [Explanation to Section 25]:
The gifts actually made by a donor and accepted by the donee are valid even without consideration. Thus, a completed gift needs no consideration.

Example: X transferred some property to Y by a duly written and registered deed as a gift. This is a valid contract even though no consideration moved.

v. Agency [Section 185]:
No consideration is necessary to create an agency.

Check your progress – 4:

What is consideration?

LESSON-5

FREE CONSENT

CONTENTS

1.5.1 Meaning of consent
1.5.2 Coercion
1.5.3 Undue influence
1.5.4 Fraud
1.5.5 Misrepresentation
1.5.6 Mistake
Check your progress: 5
Let us sum up
Lesson End Activities

1.5.1 MEANING OF CONSENT

The consent means an act of assenting to an offer. According to Section 13, “Two or more persons are said to consent when they agree upon the same thing in the same sense.” Thus, consent involves identity of minds in respect of the subject matter of the contract. In English Law, this is called ‘consensus-ad-idem‘.

Effect of absence of Consent:

When there is no consent at all, the agreement is void ab-initio, i.e. it is not enforceable at the option of either party.

Example I: X has one Maruti car and one Fiat car. He wants to sell Fiat car. Y does not know that X has two cars. Y offers to buy X’s Maruti car for Rs 50,000. X accepts the offer thinking it to be an offer for his Fiat car. Here, there is no identity of mind in respect of the subject matter. Hence there is no consent at all and the agreement is void ab-initio.

Example II: X, an illiterate woman, signed a gift deed thinking that it was a power of attorney. This gift deed was not explained to her. It was held that her mind did not go with that writing and she never intended to sign a gift deed. Hence, there was no consent at all and the agreement was void ab-initio. [Bala Devi vs. S. Majumdar].

Meaning of Free Consent [Section 14]

Free consent is one of the essential elements of a valid contract as it is evidenced by Section 10 which provides that all agreements are contracts if they are made by the free consent of the parties . . .
According to Section 14, Consent is said to be free when it is not caused by (a) coercion, or (b) undue influence, or (c) fraud, or (d) misrepresentation, or (e) mistake.

Effect of absence of Free Consent [Section 19]

When there is consent but it is not free (i.e. when it is caused by coercion or undue influence or fraud or misrepresentation), the contract is usually voidable at the option of the party whose consent was so caused.

Example: X threatens to kill Y if he does not sell his house to X. Y agreed to sell his house to X. In this case, Y's consent has been obtained by coercion and therefore, it cannot be regarded as free.

1.5.2 COERCION

Meaning of Coercion [Section 15]

Coercion means compelling a person to enter into a contract under a pressure or a threat. According to Section 15, a contract is said to be caused by coercion when it is obtained by-

a. committing any act which is forbidden by the Indian Penal Code; or

b. threatening to commit any act which is forbidden by the Indian Penal Code; or

c. unlawful detaining of any property; or

d. threatening to detain any property.

Example I: X beats Y and compels him to sell his car for Rs 50,000. Here, Y's consent has been obtained by coercion because beating someone is an offence under the Indian Penal Code.

Example II: A Hindu widow of 13 years was forced to adopt a boy under threat that her husband's dead body would not be allowed to be removed if she does not adopt the boy. She adopted the boy. Here, widow's consent has been obtained by coercion because preventing the dead body from being removed for cremation is an offence under Section 297 of the Indian Penal Code. [Ranganayakamma vs. Alwar Setti]

Note: The Indian Penal Code need not be in force in place where the coercion is employed.

Against whom/by Whom Coercion may be exercised:

Coercion may proceed from any person, and may be directed against any person, even a stranger.

Example I: X threatens to kill Z, Y's son, if Y refuses to sell his house to him. Y agrees to sell his house. Here, Y's consent has been obtained by coercion though Z is a stranger to the contract.

Example II: X threatens to kill Y if Y refuses to sell his house to Z. Y agrees to sell his house. Here, Y's consent has been obtained by coercion though X is a stranger to the contract.

Effect of threat to file a suit:

A threat to file a suit (whether civil or criminal) does not amount to coercion unless the suit is on false charge. Threat to file a suit on false charge is an act forbidden by the Indian Penal Code and thus will amount to an act of coercion.

Effect of threat to commit suicide:

A 'suicide' and a 'threat to commit suicide' are not punishable but an attempt to commit suicide is punishable under the Indian Penal Code. It does not mean that 'suicide' and threat to commit suicide are permitted by Indian Penal Code. The question whether a 'threat to commit suicide' amounts to coercion or not was considered by Madras High Court in the case of Chikham Ammiraju vs. Seshamma. In this case, a person threatened to commit suicide if his wife and son did not execute a release deed in favour of his brother in respect of certain property. It was held that though a threat to commit suicide is not punishable under the Indian Penal Code, it is deemed to be forbidden by that code. Hence, the threat to commit suicide amounted to coercion and the release deed was therefore, voidable.

The English law uses the term 'duress' for coercion. However, the two are different in the following way:

a. Duress does not include detaining of property or threat to detain property.

b. Duress can be employed only by a party to the contract or his agent.

Effects of Coercion [Sections 19, 64, 72]
The effects of coercion are as follows:

Effects	*Provision*
(a) Option of aggrieved party to avoid the contract	When consent to an agreement is obtained by coercion, the agreement is a contract voidable at the option of the party whose consent was obtained by coercion (also called aggrieved party). [Section 19]
(b) Obligation of aggrieved party to restore benefit	The party rescinding a voidable contract shall restore the benefit received by him under the contract, to the person from whom the benefit was received. [Section 64]
(c) Obligation of other party to repay or return	A person to whom money has been paid or anything delivered under coercion must repay or return it. [Section 72]

Example I: X threatens to kill Y if he does not sell his house for Rs 1,00,000 to X. Y sells his house to X and receives the payments. Here, Y's consent has been obtained by coercion. Hence, this contract is voidable at the option of Y. If Y decides to avoid the contract, he will have to return Rs 1,00,000 which he had received from X.

Example II: A railway company refused to deliver certain goods to the consignee, except upon the payment of an illegal charge for carriage. The consignee pays the sum charged in order to obtain the goods. He is entitled to recover so much of the charge as was illegally excessive.

Burden or Onus of Proof

The burden of proving that consent was obtained by coercion, and the aggrieved party would not have entered into contract had coercion been employed, lies on the party intending to avoid the contract.

1.5.3 UNDUE INFLUENCE

Meaning of Undue Influence [Section 16(1)]

The term 'undue influence' means dominating the will of the other person to obtain an unfair advantage over the other. According to Section 16(1), a contract is said to be induced by undue influence-

a. where the relations subsisting between the parties are such that one of them is in a position to dominate the will of the other, and

b. the dominant party uses that position to obtain an unfair advantage over the other.

Presumption of Domination of Will [Section 16(2)]

According to Section 16(2), a person is deemed to be in a position to dominate the will of another in the following three circumstances:

Circumstances	*Examples*
(a) Where he holds a real or apparent authority over the other	Master and servant, parent and child, Income Tax Officer and assessee, Principal and a temporary teacher
(b) Where he stands in a fiduciary relation to the other	Trustee and beneficiary, spiritual adviser (Guru) and his disciples, solicitors and client, guardian and ward
(c) Where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress	Medical attendant and patient

No Presumption of Domination of Will

According to judicial decisions held in various cases, there is no presumption of undue influence in the following relationships:

(a) Husband and wife (other than pardanashin)

(b) Landlord and tenant

(c) Creditor and debtor

Example I: X advanced Rs 10,000 to his son Y during his minority and obtained upon Y's coming of age, a bond from Y for Rs 1,00,000. Here, there is misuse of parental influence.

Example II: A poor Hindu widow agreed to pay interest at 100% p.a. because she needed the money to establish her right of maintenance. It was held that the lender was in position to dominate the will of widow. [Ranee Annpurni vs. Swaminath]

Example III: A devotee gifted her property to her spiritual guru to secure benefits to her soul in next world. It was held that spiritual guru was in position to dominate the will of devotee. [Mannu Singh vs. Umadat Pander]

Example IV: X, an illiterate old man of about 90 years, physically infirm and mentally in distress, executed a gift deed of his properties in favour of Y his nearest relative who was looking after his daily needs and managing his cultivation. It was held that Y was in a position to dominate the will of X. [Sher Singh vs. Prithi Singh]

Effect of Undue Influence [Section 19A]:

When consent to an agreement is caused by undue influence, the agreement is a contract voidable at the option of the party whose consent was so caused.

Discretion of Court:

Any such contract may be set aside either absolutely or, the party who was entitled to avoid it has received any benefit thereunder, upon such terms and conditions as the court may seem just.

Example I: A's son forged B's name to a promissory note. B, under threat of prosecuting A's son, obtains a bond from A, for the amount of the forged note. If B sues on this bond, the Court may set the bond aside.

Example II: A, a money-lender, advances Rs 10,000 to B, an agriculturist, and by undue influence, induces B to execute a bond for Rs 20,000 with interest at 6 per cent per month. The court may set the bond aside, ordering B to repay Rs 10,000 with such interest as may just.

Burden of Proof:

When a contract is avoided on the ground of undue influence, the liabilities of dominant party and weaker party to prove are as under:

The weaker party has to prove-	In case of unconscionable transaction, the dominant party has to prove that such contract was not induced by undue influence.
a. that the other party was in a position to dominate the will b. that the other party actually used his influence to obtain an unfair advantage c. that the transaction is unconscionable (unreasonable)	Note: A transaction is said to be unconscionable if the dominant party makes an exorbitant profit of the other's distress.

Contracts with Pardanashin Woman:
Meaning of Pardanashin Woman: A woman who observes complete seclusion (i.e.,who does not come in contact with people other than her family members) is pardanashin woman.
Legal Presumption: A contract with a pardanashin woman is presumed to have induced by undue influence.

Burden of Proof:

The other party who enters into a contract with a pardanashin woman must prove-

a. that he made full disclosure of all the facts to her;

b. that she understood the contracts and the implications of the contract;

c. that she was in receipt of competent independent advice before entering into the contract.

Comparison between Coercion and Undue Influence

Similarities: In case of both coercion and undue influence, the consent is not free and the contract is voidable at the option of the aggrieved party.

Distinction: Coercion differs from the undue influence in the following respects:

Basis of distinction	Coercion	Undue influence
1. Relationship	Parties to a contract may or may not be related to each other.	Parties to a contract are related to each other under some sort of relationship.
2.Consent	Consent is obtained by giving a threat of an offence or committing an offence.	Consent is obtained by dominating the will.
3. Nature of pressure	It involves physical pressure.	It involves moral pressure.

4. Who can exercise	It can be exercised even by a stranger to the contract.	It can be exercised even by a party to a contract and not by a stranger.
5.Restoration of benefit	The aggrieved party has to restore the benefit received under Sec. 64.	The party avoiding the contract may or may not return the benefit under Sec. 19A.
6.Presumption	Coercion has to be proved by the party alleging it, in no case it is presumed by the law.	It may be presumed by the law under certain circumstances. The party against whom such presumption lies must disprove it.
7.Nature of liability	The party committing the crime may be punishable under I.P.C.	It doesn't involve any criminal liability.

Rebutting Presumption

The presumption of undue influence can be rebutted by showing-

a. that the dominant party has made a full disclosure of all the facts to the weaker party before making the contract;

b. that the price was adequate; and

c. that the weaker party was in receipt of competent independent advice before entering into the contract.

1.5.4 FRAUD

Meaning and Essential Elements of Fraud [Section 17]

Meaning: The term 'fraud' means a false representation of fact made wilfully with a view to deceive the other party. Section 17 defines the fraud as follows:

'Fraud' means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him, to enter into the contract:

a. the suggestion, as to a fact, of that which is not true, by one who does not believe it to be true; e.g., X sells to Y, locally manufactured goods as imported goods charging a higher price, it amounts to fraud.

b. the active concealment of a fact by one having knowledge or belief of the fact. Mere concealment is no fraud. But where steps are taken by a seller concealing some material facts so that the buyer even after a reasonable examination cannot trace the defects, it will amount to fraud, e.g. X a furniture dealer, conceals the cracks in furniture sold by him by using some packing material and polishing it in such a way that the buyer even after reasonable examination cannot trace the defect, it would tantamount to fraud through active concealment.

c. a promise made without any intention of performing it; e.g. in Shireen vs. John, AIR(1952) Punj 227, a man and a woman underwent a ceremony of marriage with the husband not regarding it as a real marriage. Held, the husband had no intention to perform the promise from the time he made it and hence the consent of the wife was obtained under fraud.

d. any such act of omission as the law specially declares to be fraudulent, e.g. under Companies Act and Insolvency Acts, certain kinds of transfers have been declared to be fraudulent.

e. any other act fitted to deceive. It covers those acts which deceive but are not covered under any other clause.

Essential Elements:

On the basis of aforesaid definition of fraud, the essential elements of fraud are:

1. By a party to a contract:

The fraud must be committed by a party to a contract or by anyone with his connivance or by his agent. Thus, the fraud by a stranger to the contract does not affect the validity of the contract.

Example: The directors of a company issued a prospectus containing false statements. A shareholder who had subscribed for the shares on the faith of the prospectus wanted to avoid the contract. It was held that he could do so because the false statement made by directors amounted to fraud. [Reese River Silver Mining Co. vs. Smith]

2. False representation:

There must be a false representation and it must be made with the knowledge of its falsehood. Where the representation was true at the time when it was made but becomes untrue before the contract is entered into and this fact is known to the party who made the representation, it must be corrected. If it is not so corrected, it will amount to a fraud.

Example: I X fraudulently informs Y that X's estate is free from encumbrance. On the faith of X's statement, Y buys the estate. Actually the estate is subject to mortgage. Here, Y may avoid the contract because X with the intention to deceive Y induced Y to enter into a contract.

3. Representation as to fact:

The representation must relate to a fact. In other words, a mere opinion, a statement of expression or intention does not amount to fraud.

4. Actually deceived:

The fraud must have actually deceived the other party who has acted on the basis of such representation. In other words, an attempt to deceive the other party by which the other party is not actually deceived is not a fraud.

Example: X had a defective cannon. In order to conceal the defect, he put a metal plug on it. Y bought this cannon without examining. When Y used it, it brust. Y refused to pay the balance. It was held that Y was liable to pay as he was not actually deceived by fraud because he would have bought it even if no deceptive plug was inserted. [Horsefull vs. Thomas].

5. Suffered loss:

The party acting on the representation must have suffered some loss.

Effects of Fraud [Section 19]

The effects of fraud are as follows:

a. The party whose consent was caused by fraud can rescind (cancel) the contract but he cannot do so in the following cases:

i. where silence amounts to fraud, the aggrieved party cannot rescind the contract if he had the means of discovering the truth with ordinary diligence;
ii. where the party gave the consent in ignorance of fraud;
iii. where the party after becoming aware of the fraud takes a benefit under the contract;
iv. where an innocent third party before the contract is rescinded acquires for consideration some interest in the property passing under the contract,
v. where the parties cannot be restored to their original position.

b. The party whose consent was caused by fraud may, if he thinks fit, insist that the contract shall be performed and that he shall be put in the position in which he would have been if the representation made had been true.

Example: A fraudulently informs B that A's estate is free from encumbrance. B there upon buys the estate. The estate is subject to a mortgage. B may either avoid the contract, or may insist on its being carried out and the mortgage-debt redeemed.

The party whose consent was caused by fraud, can claim damage if he suffers some loss.

Silence as to fraud:

According to explanation to Section 17, "Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud."

Example I: A sells, by auction, to B a horse which A knows to be unsound. A says nothing B about the horse's unsoundness. This is not fraud by A.

Example II: A and B, being traders, enter upon a contract. A has private information of a change in prices which would affect B's willingness to proceed with the contract. A is not bound to inform B.

Example III: In Shri Krishna vs. Kurukshetra University (AIR 1976 SC 376) a candidate failed to mention the fact of shortage of attendance in the examination form. Held, no fraud.

Exceptions to the General Rule:
The general rule that silence doesn't amount to fraud has the following exceptions.

Where the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak. Such duty arises in the following two cases:

1. Where parties stand in fiduciary relationship like parent-child, trustee-beneficiary.

A sells by auction to B, a horse which A knows to be unsound. B is A's daughter and has just come of age. Here, the relation between the parties would make it A's duty to tell B if the horse is unsound.

2. Half Truth: Half truth is worse than a blatant lie. Partial truthful disclosures may easily deceive the other party, e.g. prospectus of a company disclosing only average dividend declared by the company in the last 5 years instead of the actually declining dividends over that period is a glaring example of half truth amounting to fraud.

1.5.5 MISREPRESENTATION

Meaning:

The term 'Misrepresentation' means a false representation of fact made innocently or non-disclosure of a material fact without any intention to deceive the other party. Section 18 defines the term 'misrepresentation' as follows:

"Misrepresentation" means and includes-

i. the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;

ii. any breach of duty which, without an intent to deceive, gains an advantage to the person committing it, or anyone claiming under him, by misleading another to his prejudice or to the prejudice of anyone claiming under him;

iii. causing, however innocently, a party to an agreement, to make a mistake as to the substance of the thing which is the subject of the agreement.

Essential Elements:

On the basis of the aforesaid definition of misrepresentation, the essential elements of misrepresentation are:

1. By a party to a contract:

The representation must be made by a party to a contract or by anyone with his connivance or by his agent. Thus, the representation by a stranger to the contract does not affect the validity of the contract.

2. False representation:

There must be a false representation and it must be made without the knowledge of its falsehood i.e. the person making it must honestly believe it to be true.

3. Representation as to fact:

The representation must relate to a fact. In other words, a mere opinion, a statement of expression or intention does not amount to misrepresentation.

4. Object:

The representation must be made with a view to inducing the other party to enter into contract but without the intention of deceiving the other party.

5. Actually acted:

The other party must have acted on the faith of the representation.

Effects of Misrepresentation [Section 19]:

a. Right to Rescind the Contract:

The party whose consent was caused by misrepresentation can rescind (cancel) the contract but he cannot do so in the following cases:

i. where the party whose consent was caused by misrepresentation had the means of discovering the truth with ordinary diligence;

ii. where the party gave the consent in ignorance of misrepresentation;

iii. where the party after becoming aware of the misrepresentation, takes a benefit under the contract;

iv. where an innocent third party, before the contract is rescinded, acquires for consideration some interest in the property passing under the contract;

v. where the parties cannot be restored to their original position.

b. Right to Insist upon Performance:

The party whose consent was caused by misrepresentation may if he thinks fit, insist that the contract shall be performed, and that he shall be put in the position in which he would have been if the representation made had been true.

Comparison between Fraud and Misrepresentation:

Similarities:

There are basically two similarities in case of fraud and misrepresentation as follows:

i. In both the cases, a false representation is made by a party;

ii. In both the cases, the contract is voidable at the option of the party whose consent is obtained by fraud or misrepresentation.

Distinction Fraud differs from misrepresentation in the following respects:

Basis of distinction	Fraud	Misrepresentation
1. Intention	A wrong representation is made wilfully with the intention to deceive the other party.	A wrong representation is made innocently, i.e. without any intention to deceive the other party.
2. Knowledge of falsehood	The person making the wrong statement does not believe it to be true.	The person making the wrong statement believes it to be true.
3. Right to claim damages	The aggrieved party can claim damages.	The aggrieved party cannot claim damages.
4. Availability of means to discover the truth	Except where silence amounts to fraud, the contract is voidable even if the aggrieved party had the means of discovering the truth with ordinary diligence.	The aggrieved party cannot avoid the contract if he had the means of discovering the truth with ordinary diligence.

1.5.6 MISTAKE

Meaning of Mistake [Section 20]

A mistake is said to have occurred where the parties intending to do one thing by error do something else. Mistake is an erroneous belief concerning something. The mistake can be of two types.

I. Mistake of law [Section 21]:

a. Mistake of Indian Law - The contract is not voidable because everyone is supposed to know the law of his country.

b. Mistake of Foreign Law i.e. - A mistake of foreign law is treated as mistake of fact, the contract is void if both the parties are under a mistake as to a foreign law because one cannot be expected to know the law of other country.

II. Mistake of Fact:

Mistake of fact can be either bilateral mistake or unilateral mistake.

a. Bilateral Mistake [Section 20]:

The term 'bilateral mistake' means where, both the parties to the agreement are under a mistake. According to Section 20, "Where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void." Thus, the following three conditions must be satisfied before declaring a contract void under this section:

i. Both the parties must be under a mistake

ii. Mistake must be of fact but not of law.

iii. Mistake must relate to an essential fact.

Example I: A agrees to sell to B a specific cargo of goods supposed to be on its way from England to Mumbai. It turns out that, before the date of the bargain, the shop conveying the cargo had been cast away and the goods lost. Neither party was aware of facts. The agreement is void.

Example II: A agrees to buy from B a certain horse. It turns out that the horse was dead time of the bargain, though neither party was aware of the fact. The agreement is void.

Example III: A, being entitled to an estate for the life of B, agrees to sell it to C. B was dead at the time of the agreement, but both parties were ignorant of the fact. The agreement is void.

Bilateral mistake as to the Subject matter:

An agreement is void where there is a bilateral mistake as to the subject matter. A bilateral mistake as to the subject matter includes the following:

i. Mistake as to the existence of subject matter
ii. Mistake as to the quantity of subject matter
iii. Mistake as to the quality of subject matter
iv. Mistake as to the price of subject matter
v. Mistake as to the identity of subject matter
vi. Mistake as to the title of subject matter

Example I: A agrees to buy from B a certain horse. It turns out that the horse was dead at the time of bargain though neither party was aware of the fact. The agreement is void because there is bilateral mistake as to the existence of subject matter.

Example II: A agrees to buy from B all his horses believing that B has two horses but B actually has three horses. The agreement is void because there is bilateral mistake as to the quantity of subject matter.

Example III: A agrees to buy a particular horse from B. Both believe it to be a race horse but it turns to be a cart horse. The agreement is void because there is bilateral mistake as to the quality of the subject matter.

Example IV: A agrees to buy a particular horse from B who mentioned in his letter the price as Rs 1,150 instead of 5,150. The agreement is void because there is bilateral mistake as to the price of the subject matter.

Example V: A agrees to buy from B a certain horse. B has one race horse and one cart horse. A thinks that he is buying race horse but B thinks that he is selling cart horse. The agreement is void because there is bilateral mistake as to the identity of subject matter.

Example VI: A agrees to buy a particular horse from B. That horse is already owned by A. The agreement is void because there is bilateral mistake as to the title of the subject matter.

Bilateral Mistake as to the Possibility of Performance:

The agreement is void where there is a bilateral mistake as to the possibility of performance. In other words, where the parties to an agreement believe that the agreement is capable of performance, while in fact it is not so, the agreement is treated as void. The impossibility may either be physical or legal.

b. Unilateral Mistake [Section 22]:

The term 'unilateral mistake' means where only one party to the agreement is under a mistake. According to Section 22, "A contract is not voidable merely because it was caused by one of the parties to it being under a mistake as to matter of fact."

Example: X sold Oats to Y by sample and Y, thinking that they were old Oats, purchased them. In fact, the Oats were new. It was held that Y was bound by the contract. [Smith vs. Hughes]

Exceptions: The agreement is void where a unilateral mistake relates to the identity of the person contracted with or as to the nature of the contract.

Example: A woman by falsely misrepresenting her to be wife of a well known Baron (a millionaire) obtained two pearl necklaces from a firm of jewellers on the pretext of showing them to her husband before buying. She pledged them with a broker, who in good faith paid her Rs 1,00,000. A suit was filed by the jeweller against the broker. It was held that there was no contract between the jeweller and the broker as the jeweller never intended to contract with her and as such, the broker did not get a good title and hence he must return the goods. [Lake vs. Simmons]

Example: An old illiterate man was induced to sign a Bill of Exchange by means of a false representation that it was a mere guarantee. It was held that he was not liable for the bill of exchange because he never intended to sign a Bill of Exchange. [Foster v. Mackinnon]

But the contract shall be valid and binding in spite of the mistake as to the identity of the parties in all those cases where the parties were willing to enter into contract with any person. Thus, if the mistake only relates to the attributes or motives of the person such as creditworthiness, it will not make the contract void. It may at the most make it voidable for fraud, e.g. in Phillips vs. Brooks. One Mr North entered a Jeweller's shop, selected a ring which the jeweller agreed to sell against payment by cheque which North signed in the name of Sir G B, a man of credit and standing. North pledged the ring with Brooks. In the meanwhile the cheque got dishonoured. It was held that the contract between North and the Jeweller was valid as the jeweller agreed to sell goods to the very person who entered the shop. Thus, the contract had been made before the goods were delivered to North. As the contract was induced by fraud, the jeweller could rescind the contract. However, the pledge made by North was valid. The jeweller's right was only confirmed to filing a suit against North to recover damages.

Effects of Mistake:

The effects of mistake are as follows:

(a) In case of Bilateral Mistake as to essential fact	The agreement is void.
(b) In case of Unilateral Mistake	
a. as to the identity of the person contracted with	The agreement is void
b. as to the nature of contract	The agreement is void.
c. as to other matter	The agreement is not void
(c) Obligation of aggrieved party	He must restore any benefit received by him under the contract to the other party from whom the benefit had been received [Section 64]
(d) Obligation of other party	The person to whom money has been paid or anything delivered by mistake must repay or return it. [Section 72]

Check your progress – 5:

Differentiate between Coercion and Undue influence.

LESSON- 6
LEGALITY OF OBJECT AND CONSIDERATION, AND AGREEMENTS OPPOSED TO PUBLIC POLICY

CONTENTS

1.6.1 Circumstances under which the object or consideration is deemed to be unlawful
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Check your progress: 6

1.6.1 CIRCUMSTANCES UNDER WHICH THE OBJECT OR CONSIDERATION IS DEEMED TO BE UNLAWFUL

The object and the consideration of an agreement must be lawful, otherwise, the agreement is void. According to Section 23 of The Indian Contract Act, 1872, the consideration or the object of an agreement is unlawful in the following cases:

i. If it is forbidden by Law:

If the object or the consideration of an agreement is the doing of an act which is forbidden (i.e. prohibited) by law, the agreement is void. An act is said to be forbidden by law when it is punishable either by the criminal law of the country or by special legislation.

Example I: A promises B to drop a prosecution which he has instituted against B for robbery, and B promises to restore the value of the things taken. The agreement is void, as its object is unlawful. [William vs. Bayley].

Example II: X granted a loan to the guardian of a minor to enable him to celebrate the minor's marriage. It was held that X could not recover back because agreement is void as its object (i.e., minor's marriage) is illegal. [C. Srinivas vs. K. Raja Rama Mohana Rao].

ii. If it defeats the provisions of any law:
If the object or the consideration of an agreement is of such nature that, if permitted, it would defeat the provisions of any law, the agreement is void.

Example : X borrowed Rs 1,00,000 from Y and agreed not to raise any objection as to the limitation and that Y may recover the amount even after the expiry of limitation period. This agreement is void as it defeats the provisions of the Law of Limitation Act. [Rama Murthi vs. Goppayya]

iii. If it is Fraudulent:
If the object of an agreement is to defraud others, the agreement is void.

Example : A, Band C enter into an agreement of the division among them of gains acquired, or be acquired, by them by fraud. The agreement is void, as its object is unlawful.

iv. If it Involves or Implies Injury to a Person or Property of Another:
If the object of an agreement is to injure a person or the property of another, the agreement is void.

Example : X borrowed Rs 100 from Y and executed a bond under which he promised to work for Y without pay for 2 years and agreed to pay interest at 10% per month and the principal amount at once. It was held that the agreement was void because it involved injury to X. [Ramsaroop vs. Bansi Mandar].

v. If the Court Regards it as Immoral or Opposed to Public Policy:
If the object or consideration is immoral or is opposed to the public policy, the agreement is void.

Example : A, who is B's mukhtar, promises to exercise his influence, as such, with B in favour of C, and C promises to pay Rs 1,000 to A. The agreement is void, because it is immoral.

Example : X let a flat to Yon a monthly rent of Rs 10,000. Y was a prostitute and used the flat for prostitution and did not pay the rent. X cannot recover the rent if he knew the purpose otherwise he can. [Pearce v. Brooks]

1.6.2 ILLEGAL AGREEMENTS

Illegal agreements are those agreements which are-

i. void ab-initio, i.e. void from the very beginning, and
ii. punishable by the criminal law of the country or by any special legislation/ regulation.

Effects of illegal agreements are as under:

a. The collateral transactions to an illegal agreement also become illegal and hence cannot be enforced.

b. No action can be taken for the recovery of money paid or property transferred under an illegal agreement and for the breach of an illegal agreement.

c. In case of an agreement containing the promise, some part of which is legal and other part illegal, the legal position is as under:

Example: X pays Y Rs 1,000 to beat Z. Y does not beat. X cannot recover from Y because the agreement between X and Y is illegal.

Example: X lent Rs 1,00,000 to Y to enable him to purchase certain smuggled goods from Z. X cannot recover the amount from Y if he knows the Y's purpose of borrowing.

1.6.3 VOID AGREEMENTS IF CONSIDERATION OR OBJECTS UNLAWFUL IN PART

According to Section 24, if one of the several considerations or objects of an agreement is unlawful, the agreement is void.

Example: A promises to superintend, on behalf of B, a legal manufacturer of indigo and illegal traffic of other articles. B promises 10 pay to A, a salary of Rs 10,000 a year. The agreement is void, the object of A's promise and the consideration for B's promise being in part unlawful.

1.6.4 AGREEMENTS OPPOSED TO PUBLIC POLICY

It is not easy to define the term 'Public policy' with any degree of precision because 'public policy' by its very nature, is highly uncertain and keeps on fluctuating with the passage of time. An agreement which conflicts with morals of the time and contravenes any established interest of society may be said to be opposed to public policy. In India, it has been left to Court to hold any contract as unlawful on the ground of being opposed to public policy.

The following agreements have been held to be opposed to public policy:

1. Agreements of Trading with Enemy:

   All agreements made with an alien enemy are illegal on the ground of public policy.

2. Agreement for Stifling Prosecution:

   An agreement for stifling prosecution is illegal on the ground of public policy.

Example: X, who knows that Y has committed a murder, receives Rs 7,00,000 from Y in consideration of not exposing Y. This agreement is illegal.

3. Agreements in the Nature of Maintenance and Champerty:

   Maintenance is an agreement whereby one party having no interest in suit, agrees to assist another to maintain suit. For example, X promises to pay Y Rs 5,000 if Y files a suit against Z. This is a maintenance agreement.

Champerty is an agreement whereby one party agrees to assist another in recovering property and in turn is to share in the proceeds of the action.

Example :X, agreed to pay Rs 10,000 to Y to enable him to file a suit for the recovery of his property and Y promised to give him 3/4th share in the property, if recovered. The agreement was held to be champertous and void. [Nuthahi Venkataswami vS. Katta Nagi]

Position in England: Both of these agreements are declared illegal and void.

Position in India: All of these agreements are not illegal. The Court will refuse to enforce such agreements if its object is not bonafide or the terms of reward are unreasonable in the opinion of court.

4. Agreement for the Sale / transfer of Public Offices and Titles:

   The agreements for the sale or transfer of public offices or to obtain public titles like Padma Shree, are illegal on the ground of public policy.

   Example: X promises to pay Y Rs 50,000 if Y secures him an employment in Govt. service. This agreement is opposed to public policy.

5. Agreements in Restraint of Parental Rights:

   An agreement which prevents a parent to exercise his right of guardianship is void on the ground of public policy.

6. Agreements in Restraint of Personal Liberty:

   An agreement which unduly pets the personal liberty of any person is void on the ground of public policy.

7. Agreement Tending to Create Monopoly:

   An agreement which tends to create monopoly is void on the ground of public policy.

8. Agreements Interfering with Course of Justice:

   An agreement which interferes with course of justice is void on the ground of being opposed to public policy.

9. Marriage Brokerage Contracts:

   A marriage contract is one whereby one or persons receives money or money's worth in consideration of marriage.

10. Agreement in Restraint of Marriage [Section 26]:

    Every agreement in restraint of marriage of any person other than a minor is void.

11. Agreement in Restraint of Trade [Section 27]:

    Every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any is to that extent void.

12. Agreement in Restraint of Legal Proceeding [Section 28]:

    An agreement which restricts a party absolutely from enforcing his legal rights arising under a contract or an agreement which curtails the period of limitation within which the rights may be enforced is void.

1.6.5 VOID AGREEMENTS AND CONTINGENT CONTRACTS

According to Section 2(g) of the Indian Contract Act, 1872, a void agreement is an agreement which is not enforceable by law. The agreements which are not legal by law right from the time when they are made are void-ab-initio.

The following types of agreements have expressly been declared void under sections of the Indian Contract Act.

i. Agreements by or with persons incompetent to contract (Sections 10 & 11).
ii. Agreements entered into through a mutual mistake of fact between the parties (Section 20).
iii. Agreement, the object or consideration of which is unlawful (Section 23).
iv. Agreement, the consideration or object of which is partly unlawful (Section 24).
v. Agreement made without consideration (Section 25).
vi. Agreements in restraint of marriage (Section 26).
vii. Agreements in restraint of trade (Section 27).
viii. Agreements in restraint of legal proceedings (Section 29).
ix. Wagering agreement (Section 30).
x. Impossible agreement (Section 56).
xi. An agreement to enter into an agreement in the future.

Agreements in restraint of marriage:
According to Section 26 of the Indian Contract Act, every agreement in restraint of the marriage of any person other than a minor is void.

Example I: X promised to marry Y only and none else, and to pay Rs 2,000 in default. X married Z and Y sued X for recovery of Rs 2,000. It was held that Y could not recover anything because the agreement was in restraint of marriage. [Lowe vs. Peers]

It may be noted that an agreement which provides for a penalty upon remarriage may not be considered as a restraint of marriage.

Example II: An agreement between two co-widows that if one of them remarried, she should forfeit her right to her share in the deceased husband's property, was not void because no restraint was imposed upon either of the two widows from remarrying. [Roa Rani vs. Gulab Rani]

1.6.6 AGREEMENTS IN RESTRAINT OF TRADE

According to Section 27 of Indian Contract Act, 1872, "every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void." This is because Article 19(g) of the Constitution of India regards the freedom of trade and commerce as a right of every individual. Therefore, no agreement can deprive or restrain a person from exercising such a right.

Onus of Proof :
Where an agreement is challenged on the ground of its being in restraint of trade, the party supporting the contract must show that the restraint is reasonably necessary to protect his interests, and the party challenging the contract must show that the restraint is injurious to the public.

Meaning of Expression 'that Extent':
The expression 'that extent' may be interpreted in the sense that only that portion of such agreement is void which is considered either as unreasonable or as opposed to public policy being in restraint of trade. The rest of the agreement would continue to be valid.

Example : X and Y carried on business in a certain locality in Calcutta. X promised to stop business in that locality if Y paid him Rs 1,000. X stopped his business but Y did not pay him the promised money. It was held that X could not recover anything from Y because the agreement was in restraint of trade and was thus void. [Madhub Chander vs. Raj Coomer}

Exceptions to the Rule that 'An Agreement in Restraint of Trade is Void':
The exceptions here mean the cases where agreements in restraint of trade are not considered as void.

I. Exceptions Under Statutory Provisions:

1. Sale of Goodwill [Exception 1 to Section 27]:

An agreement which restrains the seller of a goodwill from carrying on a business is valid if all the following conditions are fulfilled:

a. Such restriction must relate to a similar business.
b. Such restriction must be within specified local limits.
c. Such restriction must be for the time so long as the buyer or any person deriving title to the goodwill from him carries on a like business in the specified local limits.
d. Such specified local limits must be reasonable having regard to the nature of the business.

Thus, the buyer of goodwill may restrain the seller for carrying on any business “to the one sold by him within certain vicinity and for a certain period of time provided the restrictions in regard to time and vicinity are found reasonable.

2. Partners Agreements:

The Indian Partnership Act, 1932, recognises the following agreements in restraint of trade as valid:

a. Restriction on existing partner [Section 11 (2)]-A partner shall not carry on any business other than that of the firm while he is a partner.
b. Restriction on outgoing partner [Section 36(2)]-An outgoing partner may agree with his partners that he will not carry on any business similar to that of the firm within a specified period or within specified local limits. Such agreement shall be valid only if the restrictions are reasonable.
c. Restriction on partners upon or in anticipation of the dissolution of the firm [Section 54]-Partners may, upon or in anticipation of the dissolution of the firm, make an agreement that some or all of them will not carry on a business similar to that of the firm within a specified period or within specified local limits. Such agreement shall be valid only if the restrictions are reasonable.
d. Restriction in case of sale of goodwill [Section 55(3)]-A partner may upon the sale of the goodwill of a firm, make an agreement that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits. Such agreement shall be valid if the restrictions are reasonable.

II. Exceptions under Judicial Interpretations:

1. Trade Combinations:
   Trade combinations which have been formed to regulate the business or to fix prices are not void, but the trade combinations which tend to create monopoly and which are against the public interest are void.

Example: An agreement among four ginning factories to fix uniform rate for ginning cotton and to divide the profits in a certain proportion is not void because such agreements are neither in restraint of trade nor opposed to public policy. [Haribhai vs. Sharafali]

2. Sole Dealing Agreements:
   An agreement to deal in the products of a single manufacturer or to sell the whole produce to a single dealer are valid if their terms are reasonable.

Example: An agreement by a person to sell all the mica produced by him to the plaintiffs and not to any other firm, and not to keep any in stock, is valid. [Subha Naidu vs. Haj Badsha Sahib]

3. Service Agreements:
   A clause in service agreement may or may not be in restraint of trade. An analysis of some of the clauses of service agreement is as under:

1.6.7 WAGERING AGREEMENTS (SEC. 30)

Meaning of Wagering Agreements

An agreement between two persons under which money or money's worth is payable by one person to another on the happening or non-happening of a future uncertain event is called a wagering event. Such agreements are chance oriented and therefore, completely uncertain.

Example: X promises to pay Rs 1,000 to Y if it rained on a particular day, and Y promises to pay Rs 1,000 to X if it did not. Such agreement is a wagering agreement.

Essentials of a Wagering Agreement:

a. Promise to Pay Money or Money's Worth:
   The wagering agreement must contain a promise to pay money or money's worth.

b. Uncertain Event:
   The performance of the promise must depend upon the determination of an uncertain event. An event is said to be uncertain when it is yet to take place or it might have already happened but the parties are not aware of its result.

c. Mutual Chances of Gain or Loss:
   Each party must stand to win or lose upon the determination of an uncertain event. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering agreement.

d. Neither Party to have Control over the Event:
Neither party should have control over the happening of the event one way or the other.

e. No other Interest in the Event:
Neither party should have interest in the happening or non-happening of the event other than the sum or stake he will win or lose.

Examples of Wagering Agreements:

a. An agreement to settle the difference between the contract price and market price of certain goods or shares on a particular day.

b. A lottery (i.e. a game of chance). But parties running a Govt. approved lottery cannot be prosecuted .

c. An agreement to buy a lottery ticket.

d. A crossword puzzle in which prizes depend upon correspondence of the competitor's solution with a previously prepared solution kept with the Editor of newspapers is a lottery and hence a wagering transaction.
[State of Bombay vs. R.M.D. Chamarbaugwala]. But a crossword puzzle is generally a game of skill and intelligence and hence not a wager.

Examples of Transactions Held not Wagers:

a. Prize competitions which are games of skill, e.g., picture puzzles, athletic competitions. For example, an agreement to enter into a wrestling event in which winner was to be rewarded by the entire sale proceeds of tickets was held not to be a wagering contract. [Babasaheb vs. Rajaram]

b. According to the Prize Competition Act, 1955, prize competition in games of skill are not wagers provided the prize money does not exceed Rs 1,000.

c. An agreement to contribute to a plate or prize of the value of above Rs 500 to be awarded to the winner of a horse race. [Section 30]

d. Contracts of insurance.

Effects of Wagering Agreements [Section 30]:

The effects of wagering agreements are given as under:

i. Agreements by way of wager are void in India.
ii. Agreements by way of wager have been declared illegal in the states of Maharashtra and Gujarat.

iii. No suit can be filed to recover the amount won on any wager.

iv. Transaction which are collateral to wagering agreements are not void in India except in the states of Maharashtra and Gujarat.

v. Transactions which are collateral to wagering agreements are illegal in the states of Maharashtra and Gujarat.

Example: A Cricket match is to be held between India and Pakistan. X agrees to pay Rs 1,00,000 to Y if India wins the match and agrees to deposit the money with Z, a third person of confidence for this purpose. X borrows Rs 1,00,000 from W. The implications of this case are summarised as under:

a. The agreement between X and Y is a wagering agreement because the performance of an agreement depends upon the happening or non-happening of a future uncertain event and each party stands to win or lose.

b. If India wins the match, Y (a winner) cannot recover the amount but X (a loser) can recover if the amount has not been paid to Y. Thus, a winner cannot recover the amount but a loser can if the amount has not been paid to the winner.

c. If India wins the match and Z (a stakeholder) pays the money to Y (a winner), X (a loser) cannot recover it from Z. [Bridger vs. Savage]

d. The agreement between X and W which is a collateral to wagering agreement, is valid in India except in the States of Maharashtra and Gujarat. Thus, W can recover the money from X if the agreement between X and Y is entered into in India except in the States of Maharashtra and Gujarat but W cannot recover the money from X if the agreement between X and Y is entered into in the States of Maharashtra or Gujarat

AGREEMENTS CONTINGENT ON IMPOSSIBLE EVENTS [SEC. 36]

According to Section 36 of the Indian Contract Act, 1872 contingent agreements to do or not to do anything, if an impossible event happens are void whether the impossibility of the event is known or not to the parties to the agreement at the time it is made.

Example: A agrees to pay Rs 1,000 if B marries C (a Hindu) who is already married to D. This agreement is void.

AGREEMENTS TO DO IMPOSSIBLE ACTS [Section. 56]:

According to Section 56 of the Indian Contract Act, 1872, “An agreement to do an impossible act is void.”

Example: A undertakes to put life into the dead wife of B. This agreement is void.

1.6.8 RESTITUTION [SECTIONS. 64 AND 65]

Restitution means 'return or restoration of benefit.' The provisions relating to restitution are given below:

Case	*Provision*
When a person at whose option a contract is voidable rescinds it [Section 64].	The party rescinding a voidable contract must restore the benefit to the person from whom he has received it.
When an agreement is discovered 11) be void or the contract becomes void [Section 65].	The person who has received any benefit or advantage under such agreement or contract must restore it or compensate for it to the person from whom he has received it.

Example I: A, a singer contracts with B the manager of a theatre to sing at his theatre for two nights every week during the next two months and B agrees to pay her Rs 100 for each night's performance. On the sixth night, A wilfully absents herself from the theatre and B in consequence rescinds the contract, B must pay A for the five nights on which she had sung.

Example II: A contracts to sing for B on a specified day and receives an advance of Rs 1,000 but is unable to sing due to serious illness on that day. Since the contract has become void. A must return Rs 1,000 to B.

Non-applicability of the Principle of Restitution:

The principle of restitution does not apply to contracts which are void ab-initio with the exception where the minor has entered into agreement by misrepresenting his age.

Example I: X pays Rs 1,000 to Y to beat Z. Y does not beat Z. X claims Rs 1,000 from Y. X cannot recover anything because this agreement is void ab-initio.

Example II: X advances Rs 10,000 to Y, a married woman to enable her to obtain a divorce from her husband. Y agrees to marry X as soon as she obtained a divorce. Y obtains the divorce but refuses to marry X. X cannot recover anything from Y because this agreement is void ab-initio. [Baiviji vs. Hamda Nagar].

1.6.9 QUASI-CONTRACTS

Meaning

A Quasi-contract is not a contract at all because one or the other essentials for the formation of a contract are absent. It is an obligation imposed by law upon a person for the

benefit of another even in the absence of a contract. It is on the principle of equity, which means no person shall be allowed to unjustly enrich himself at the expense of another. Such obligations are called quasi-contracts or implied contracts because the outcome of such obligations resemble those created by a contract.

Features of a Quasi-contract:

The salient features of a quasi contract are as under:

i. It is imposed by law and does not arise from any agreement.

ii. The duty of a party and not the promise of any party is the basis of such contract.

iii. The right under it is always a right to money and generally, though not always, to a liquidated sum of money.

iv. The right under it is available against specific person(s) and not against the world.

v. A suit for its breach may be filed in the same way as in case of a complete contract.

QUASI-CONTRACTS AND OTHER CONTRACTS
Distinction between Quasi-Contracts and Contracts

Quasi-contracts differ from other contracts in the following respects:

Basis of distinction	*Quasi-contract Contract*	*Contract*
1. Essential for the formation of a valid contract	The essentials for the formation of a valid contract are absent.	The essentials for the formation of a valid contract are present.
2. Obligation	Obligation is imposed by law.	Obligation is created by the consent of the parties.

Check your progress – 6:

Discuss the agreements that are opposed to public policy.

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LESSON-7

PERFORMANCE OF A CONTRACT

CONTENTS

1.7.1 Types of performance

1.7.2 Effects of Tender

1.7.3 Essentials of a valid tender

1.7.4 Effect of refusal of party to perform promise wholly

1.7.5 Persons who can demand performance

1.7.6 Persons who must perform

Check your progress: 7

Performance of the contract is one of the various modes of discharge of the contract. A contract is said to have been performed when the parties to a contract either perform or offer to perform their respective promises. Section 37 of the Indian Contract Act lays down the obligation of the parties regarding performance. According to this section,

“The parties to a contract must either perform or offer to perform their respective promises, unless such performance is dispensed with or excused under the provisions of this Act, or of any other law.”

1.7.1 TYPES OF PERFORMANCE

There may be two types of performance as follows:

a. Actual Performance:

Where a promisor has made an offer of performance to the promisee and the offer has been accepted by the promisee, it is called an actual performance.

Example: X contracted to deliver to Y at his warehouse on 1st Oct., 100 bales of cotton of particular quality. X brought the cotton of requisite quality to the appointed place on the appointed day during the business hours, and Y took the delivery of goods. This is an actual performance.

b. Attempted Performance (or Tender) [Section 38]

Where a promisor has made an offer of performance to the promisee, and the offer has not been accepted by the promisee, it is called an attempted performance (Section 38).

Example: If in the aforesaid example, Y refused to take the delivery of goods, it is a case attempted performance because X has done what he was required to do under the contract.

1.7.2 EFFECTS OF TENDER

There are two effects of tender as under:

a. The promisor is not responsible for non-performance.

b. The promisor does not lose his rights under the contract.

Types of tender

Types of tender	*Meaning*	*Effects*
1. Tender of goods or services	Where the promisor offers to deliver the goods or services but the promisee refuses to accept the delivery.	a. Goods or services need not be offered again. b. Promisor may sue the promisee for non-performance c. Promisor is discharged from his liability.
2. Tender of money	Where the promisor offers to pay the amount but the promisee refuses to accept the same.	a. Promisor is not discharged from his liability to pay the amount. b. Promisor will not be liable for interest from the date of a valid tender.

1.7.3 ESSENTIALS OF A VALID TENDER

1. Unconditional:
   It must be unconditional. Tender is said to be unconditional when it is made in accordance with the terms of the contract.

Example: X offers to deliver 100 bales of cotton to Y if Y sells his one machine to X. It is a conditional tender and hence invalid.

2. At Proper Time:
   It must be at proper time, i.e. at the stipulated time (if there is an agreement as to time) or during business hours (if there is no agreement as to time). Tender of goods or money before the due date is also not a valid tender.

3. At Proper Place:
   It must be at proper place, i.e. at the stipulated place (if there is an agreement as to place) or at promisee’s business place (if there is business) or at promisee's residence (if there is no business place).

4. Reasonable Opportunity to Promisee:
   It must give a reasonable opportunity to the promisee of ascertaining that the goods offered are the same as the promisor is bound to deliver.

5. For Whole Obligation:
   It must be for the whole obligation and not for a part of the whole obligation. However, a minor deviation from the terms of the contract may not render the tender invalid.

Example: Delivery of 100.10 tons of wheat in a contract for 100 tons of wheat is a valid r but delivery of 120 tons of wheat is invalid tender.

6. To Proper Person:
   It must be made to the promisee or his duly authorised agent. In case of several joint promisees, a tender made to one of them has the same legal consequences as tender to all of them.

7. Of Exact Amount and in Legal Tender:
   In case of tender of money, it must be of exact amount and in legal tender.

1.7.4 EFFECT OF REFUSAL OF PARTY TO PERFORM PROMISE WHOLLY

When a party to a contract has refused to perform or disabled himself from performing his promise in its entirety, the promisee may put an end to the contract, unless he has signified, by words or conduct, his acquiescence in its continuance.

Example I: A, a singer enters into a contract with B, the manager of a theatre, to sing at theatre two nights in every week during the next two months, and B engages to pay her 100 for each night’s performance. On the sixth night, A wilfully absents herself from the theatre. B is at liberty to put an end to the contract.
Example II: A, a singer enters into a contract with B, the manager of a theatre, to sing at theatre two nights every week during the next two months and B engages to pay her at rate of Rs 100 for each night. On the sixth night, A wilfully absents herself. With the assent of B, A sings on the seventh night. B has signified his acquiescence in the continuation of the contract, and cannot now put an end to it, but is entitled to compensation for damage sustained by him through A’s failure to sing on the sixth night.

1.7.5 PERSONS WHO CAN DEMAND PERFORMANCE

The persons who can demand performance are:

1. Promisee:
   Promisee can only demand the performance of the promise under a contract. For example, X promises Y to pay Rs 1,000 to Z. It is only Y who can demand performance and not Z.

2. Legal Representative:
   In case of death of the promisee, his legal representative can demand performance unless a contrary intention appears from the contract or the contract is of a personal nature. For example, X promises to marry Y on the specified day. Y dies before the specified day. The legal representatives Y cannot demand performance of the promise from X because the contract is of personal nature.

3. Third Party:
   A third party can also demand the performance of the contract in some exceptional cases like beneficiary in case of trust, the person for whose benefit the provision is made in family arrangements.

4. Joint Promisees:
   In case of several promisees, unless a contrary intention appears, the performance can be demanded by the following persons:

Case	*Who can demand the performance of promise*
I. In case all the promisees are alive	All the promisees jointly.
II. In case of death of any of joint promisees	Representatives of deceased promisee jointly with the surviving promisee(s)
III. In case of death of all joint promisees	Representatives of all of them jointly.

Example: X promises Y and Z jointly to repay loan of Rs 1,000 on a specified day. Y dies before that specified day. Y's representative jointly with Z can demand the performance from X on specified day. If Y and Z die before that specified day, the representatives of Y and Z jointly can demand the performance from X on specified day.

1.7.6 PERSONS WHO MUST PERFORM

1. Promisor:

   If it appears from the nature of the case that it was the intention of the parties to any contract that any promise contained in it should be performed by the promisor himself, such promise must be performed by the promisor.

Example I: X promises to marry Y. X must perform this promise personally.

Example II: X promises to paint a picture for Y. X must perform the promise personally.

2. Promisor’s Agent:
   If it was not the intention of the parties that the promise be performed by the promisor himself, such contracts can be performed by the promisor himself or any competent person employed by him.

Example: A promises to pay B a sum of money. A may perform this promise either by personally paying the money to B, or by causing it to be paid to B by another, and if A dies before the time appointed for payment, his representatives must perform the promise, or employ some proper person to do so.

3. Legal Representatives:
   In case of death of promisor, his legal representative can perform the contract unless a contrary intention appears or the contract is of personal nature .

Example: X promises to marry Y. X dies. X’s legal representative cannot perform this promise.

4. Third Party [Section 41]:
   A contract can be performed by a third party if the promisee accepts the arrangement. According to Section 41, when a promisee accepts performance of the promise from a third person, he cannot afterwards enforce it against the promisor.

5. Joint Promisors [Section 42]:
   In case of several promisors, unless a contrary intention appears, the following persons must perform the promise:

Case	*Who must perform the promise*
In case all the promisors are alive	All the promisors jointly.
In case of death of any of joint promisors	Representatives of the deceased promisor jointly with the surviving promisor(s).
In case of death of all joint promisors	Representatives of all of them jointly.

Check your progress – 7:

Who can demand performance of contracts?

LESSON-8
DISCHARGE OF A CONTRACT

CONTENTS

1.8.1 Modes of discharge of contract

Check your progress: 8

Discharge of a contract means termination of the contractual relations between the parties to a contract. A contract is said to be discharged when the rights and obligations of the parties under the contract come to an end.

1.8.1 MODES OF DISCHARGE OF CONTRACT

A contract may be discharged in various modes.

I. Discharge by Performance:
A contract can be discharged by performance in any of the following ways:

1. Actual Performance:
A contract is said to be discharged by actual performance when the parties to the contract perform their promises in accordance with the terms of the contract.

2. Attempted Performance or Tender:
So far as the tenderer of performance is concerned, a contract is said to be discharged by attempted performance when the promisor has made an offer of performance to the promisee but it has not been accepted by the promisee.

II. Discharge by Mutual Agreement

Since a contract is created by mutual agreement, it can also be discharged by mutual agreement. A contract can be discharged by mutual agreement in any of the following ways:

1. Novation [Section 62]:
Novation means the substitution of a new contract for the actual contract. Such a new contract may be either between the same parties or between different parties. The consideration for the new contract is the discharge of the original contract.

Example: A owes money to B under a contract. It is agreed between A, B and C that B shall henceforth accept C as his debtor, instead of A. The old debt of A to B no longer exists a new debt from C to B has been contracted.

2. Rescission [Section 62]:
Rescission means cancellation of the contract by any or all the parties to a contract.

Example: X promises Y to sell and deliver 100 Bales of cotton on 1st Oct. at his godown and Y promises to pay for goods on 1st Nov. X does not supply the goods. Y may rescind the contract.

3. Alteration [Section 62]:
   Alteration means a change in the terms of a contract with mutual consent of the parties. Alteration discharges the original contract and creates a new contract. However, parties to the new contract must not change.

Example: X promises to sell and deliver 100 bales of cotton on 1st Qct. and Y promises to pay for goods on 1st Nov. Afterwards, X and Y mutually decide that the goods shall be delivered in five equal instalments at Z's godown. Here, original contract has been discharged and a new contract has come into effect.

4. Remission [Section 63]:
   Remission means acceptance by the promisee of a lesser fulfilment of the promise made. According to Section 63, "Every promisee may dispense with or remit, wholly or in part, the performance of the promise made to him, or may extend the time for such performance, or may accept instead of it any satisfaction which he thinks fit."

Example I: A promises to paint a picture for B. B afterwards forbids him to do so. A is no longer bound to perform the promise.

Example II: A owes B Rs 5,000. A pays to B, and B accepts, in satisfaction of the whole debt Rs 2,000 paid at the time and place at which Rs 5,000 were payable. The whole debt is discharged.

5. Waiver:
   Waiver means intentional relinquishment of a right under the contract. Thus, it amounts to releasing a person of certain legal obligation under a contract. e.g., A promises to supply goods to Y. Subsequently, Y exempts X from carrying out the promise. This amounts to waiving the right of performance on the part of Y.

III. Discharge by Operation of Law

A contract may be discharged by operation of law in the following cases:

1. By Death of the Promisor;
   A contract involving the personal skill or ability of the promisor is discharged on the death of the promisor.

2. By Insolvency:
   When a person is declared insolvent, he is discharged from his liability up to the date of his insolvency.

3. By Unauthorised Material Alteration:
   If any party makes any material alteration in the terms of the contract without the approval of the other party, contract comes to an end.

4. By the Identity of Promisor and Promisee:
   When the promisor becomes the promisee, the other parties are discharged.

Example: X draws a bill receivable on Y who accepts the same. X endorses the bill in favour of Z who in turn endorses in favour of Y. Here, Y is both promisor and promisee and hence the other parties are discharged.

IV. Discharge by impossibility of Performance.

The effects of impossibility of the performance of a contract may be discussed under the following two heads:

1. Effects of Initial Impossibility [Section 56 Para 1 and 3]:
   Initial impossibility means the impossibility existing at the time of making the contract.

2. Effects of Supervening Impossibility [Section 56 Para 2]:
   Supervening impossibility means impossibility which does not exist at the time of making the contract but which arises subsequently after the formation of the contract.

Cases when a Contract is discharged on the Ground of Supervening Impossibility:

A contract is discharged by supervening impossibility in the following cases:

a. Destruction of Subject Matter:
   The contract is discharged if the subject matter the contract is destroyed after the formation of the contract without any fault of party.

Example: X agreed to sell his crop of wheat. The entire crop was destroyed by fire though fault of the party. The contract was discharged.

b. Death or Personal Incapacity:
   The contract is discharged on the death or incapacity or illness of a person if the performance of a contract depends on his personal skill or ability.

Example: X agreed to sing on a specified day. X fell seriously ill and could not perform on that day. The contract was discharged.

c. Declaration of war:
   The pending contracts at the time of declaration of warvare either suspended or declared as void.

Example: X contracts to take in cargo for Y at a foreign port. X's government afterwards declares war against the country in which the port is situated. The contract becomes when void when the war is declared.

d. Change of Law:
The contract is discharged if the performance of the con becomes impossible or unlawful due to change in law after the formation of contract.

Example: X agreed to sell his land to Y. After the formation of the contract, the Government issued a notification and acquired the land. The contract was discharged. [Shyam Sunder vs. Durga]

e. Non-existence or Non-occurrence of a Particular State of Things necessary for performance:
The contract is discharged if that particular state of thing which forms the basis of a contract ceases to exist or occur.

Example: X and Y contract to marry each other. Before the time fixed for the marriage, X goes mad. The contract becomes void.

Cases when the Contract is not discharged on the Ground of Supervening Impossibility:

Impossibility of performance is, as a rule, not an excuse from performance. It means that when a person has promised to do something, he must perform his promise unless the performance becomes absolutely impossible. A contract is discharged by the supervening impossibility in the following cases:

a. Difficulty of Performance:
A contract is not discharged simply on the ground that its performance has become more difficult, more expensive or less profitable than that agreed at the time of its formation.

Example: X agreed to supply coal within a specified time. He failed to supply in because of government's restriction on the transport of coal from collieries. Here X will be discharged because the coal was available in the open market from where X could have obtained it.

b. Commercial Impossibility:
A contract is not discharged simply on the ground of commercial impossibility, i.e. when the contract becomes commercially unviable or unprofitable.

Example : X, a furniture manufacturer agreed to supply certain furniture to Y at an agreed rate. Afterwards, there was a sharp increase in the rates of the timber and rates of wages. Since it was no longer profitable to supply at the agreed rate, X did not supply. X will not be discharged on the ground of commercial impossibility.

c. Default of a Third Party:
A contract is not discharged if it could not be performed because of the default of a third party on whose work the promisor relied.

Example: X entered into a contract with Y for the sale of goods to be manufactured by Z, a manufacturer of those goods. Z did not manufacture those goods. X will not be discharged be and will liable to Y for damages.

d. Strikes, Lockouts and Civil Disturbances:
A contract is not discharged on the grounds of strikes, lockouts and civil disturbances unless otherwise agreed by the parties to the contract.

Example: X agreed to supply to Y certain goods to be imported from Algeria. The goods could not be imported due to riots in that country. It was held that this was no excuse for non-performance of the contract. [Jacobs vs. Credit Lyonnais]

e. Partial Impossibility:
A contract is not discharged simply on the ground of impossibility of some of the objects of the contract.

V. Discharge by lapse of time

A contract is discharged if it is not performed or enforced within a specified period, called period of limitation. The Limitation Act, 1963 has prescribed the different periods for different contracts, e.g. period of limitation for exercising right to recover a debt is 3 years, and to recover an immovable property is 12 years. The contractual parties cannot exercise their rights after the expiry of period of limitation.

VI. Discharge by breach of contract

A contract is said to be discharged by breach of contract if any party to the contract refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract. A breach of contract may occur in the following two ways:

1. Anticipatory Breach of Contract:
Anticipatory breach of contract occurs when the party declares his intention of not performing the contract before the performance is due.

2. Actual Breach of Contract:
Actual breach of contract occurs in the following two ways:

a. On Due Date of Performance:
If any party to a contract refuses or fails to perform his part of the contract at the time fixed for performance, it is called an actual breach of contract on due date of performance.

b. During the Course of Performance:
If any party has performed a part of the contract and then refuses or fails to perform the remaining part of the contract, it is called an actual breach of contract during the course of performance.

Consequences of Breach of Contract:
The aggrieved party (i.e. the party not at fault) is discharged from his obligation and gets rights to proceed against the party at fault.

Check your progress – 8:

How can contracts be discharged?

LESSON-9

REMEDIES FOR BREACH OF CONTRACT

CONTENTS

1.9.1 Consequences of breach of contract
1.9.2 Remedies for breach of contract
Check your progress: 9
Lesson End Activities

A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract. In case of breach, the aggrieved party (i.e. the party not at fault) is relieved from performing his obligation and gets a right to proceed against the party at fault. A breach of contract may arise in two ways,

1. Anticipatory Breach of Contract:
   Anticipatory breach of contract occurs when the party declares his intention of not performing the contract before the performance is due.

2. Actual Breach of Contract:
   Actual breach of contract occurs in the following two ways:

i. On Due Date of Performance:
   If any party to a contract refuses or fails to perform his part of the contract at the time fixed for performance, it is called an actual breach of contract on due date of performance.

ii. During the Course of Performance:
   If any party has performed a part of the contract and then refuses or fails to perform the remaining part of the contract, it is called an actual breach of contract during the course of performance.

1.9.1 CONSEQUENCES OF BREACH OF CONTRACT

The aggrieved party (i.e. the party not at fault) is discharged from his obligation and gets rights to proceed against the party at fault.

Options Available to Aggrieved Party [Section 39]:

In case of anticipatory breach, the aggrieved party has the following two options

1. He can rescind the contract and claim damages for breach of contract without waiting until the due date for performance, or
2. He may treat the contract as operative and wait till the due date for performance and claim damages if the promise still remains unperformed.

Consequences of Treating Contract as Operative:

In case of anticipatory breach, if the aggrieved party treats the contract as operative and waits till the due date for performance, the consequences will be as follows:

1. The promisor may perform his promise on or before the due date of performance and the promisee will be bound to accept the performance.
2. The promisor may take advantage of the discharge by supervening impossibility arising between the date of breach and the due date of the performance and in such a case, the promisee shall lose his right to sue for damages.

Amount of Damages:

The amount of damages in each of the options exercised by an aggrieved party will be calculated as under:

Option exercised	*Amount of damages*
1. When the aggrieved party rescinds the contract at the date of breach	The amount of damages will be equal to the difference between the prices prevailing on the date of breach and the contract price.
2. When the aggrieved party does not rescind the contract at the date of breach	The amount of damages will be equal to the difference between the price prevailing on the due date of performance and the contract price.

ACTUAL BREACH OF CONTRACT

Actual breach of contract may take place in any of the following two ways:

1. On due Date of Performance:
   If any party to contract refuses or fails to perform his part of the contract at the time fixed for performance, it is called an actual breach of contract on due date of performance.

Example: X agreed to sell to Y 10 tons of wheat @ Rs 8,000 per ton to be delivered in two instalments on 20th October and on 21st October. On 20th October, X refused to deliver the goods. It is an actual breach of contract on due date of performance.

2. During the Course of Performance:
   If any party has performed a part of the contract and then refuses or fails to perform the remaining part of the contract, it is an actual breach of contract during the course of performance.

Example: X agreed to sell to Y 10 tons of wheat@ Rs 8,000 per ton to be delivered in two instalments on 20th October and 21st October. On 20th October, X delivered 5 tons and refused to deliver remaining 5 tons. It is an actual breach of contract during the course of performance.

1.9.2 REMEDIES FOR BREACH OF CONTRACT

Meaning of Remedy

A remedy is the course of action available to an aggrieved party (i.e. the party at default) for the enforcement of a right under a contract.

I. Rescission of contract [Section 39]:
   Rescission means a right not to perform obligation.
   In case of breach of a contract, the promisee may put an end to the contract. In case, the aggrieved party is discharged from all the obligations under the contract and is entitled to claim compensation for the damage which he has sustained because of the non-performance of the contract.

II. Suit for Damages:
   Damages are monetary compensation allowed for loss suffered by the aggrieved party due to breach of a contract. The object of awarding damages is not to punish the party at fault but to make good the financial loss suffered by the aggrieved party due to the breach of contract.

Compensation for Loss or Damage Caused by Breach of Contract [Section 73]:
Section 73, of the Indian Contract Act which deals with compensation for damage caused by breach of contract is based on the judgement in the previous cases of such nature. It states that the aggrieved party may claim the damages as follows:

i. Ordinary Damages:

   Ordinary damages are those which naturally arise in the usual course of things from such breach. These damages can be recovered if the following two conditions are fulfilled:

a. The aggrieved party must suffer by breach of contract, and

b. The damages must be proximate (i.e. direct) consequence of the breach of contract and not the indirect consequence.

Measure of Ordinary Damages: In a contract for the sale of goods, the measure of ordinary damages is the difference between the contract price and the market price of such goods on the date of breach.

ii. Special Damages:
Special damages are those which may reasonably be supposed to have been in the contemplation of both parties as the probable result of the breach of a contract. These damages can be recovered if the special circumstances which would result in a special loss in case of breach of a contract are communicated to the promisor, e.g. loss of profits on account of default by the other party to the contract can be claimed only when an advance notice of such damages has been given before.

iii. Exemplary or Punitive or Vindictive Damages;
Exemplary damages are those which are in the nature of punishment. The court may award these damages in case of

a. a breach of promise to marry, where damages shall be calculated on the basis of mental injury sustained by the aggrieved party,

b. wrongful dishonour of a cheque by a banker. In case of wrongful dishonour of a cheque, the rule is smaller the amount of the cheque, larger will be the amount of damages awarded. A trader may recover such damages as wrongful dishonour of cheque shall adversely affect his goodwill but a non-trader whose cheque is wrongfully dishonoured will have to prove the loss of goodwill before claiming such damages.

iv. Nominal Damages:
Nominal damages are those which are awarded where there is only a technical violation of a legal right but the aggrieved party has not in fact suffered any loss because of breach of contract. These damages are called nominal because they are very small, say, one rupee. The court may or may not award these nominal damages.

v. Damages for inconvenience and discomfort:
If a party has suffered physical inconvenience and discomfort due to breach of contract, that party can recover the damages for such inconvenience and discomfort.

vi. Liquidated damages and penalty:

When the parties to a contract at the time of formation of contract, specify a sum which will become payable by the party responsible for breach, such specified sum is called:

a. *Liquidated Damages* if the specified sum represents a fair and genuine pre-estimate of the damages likely to result due to breach;

b. *Penalty* if the specified sum is disproportionate to the damages likely to result due to breach.

vii. Stipulation of Interest:
The stipulation of interest may or may not be in the nature of penalty. If the stipulation for interest is in the nature of penalty, the court may award reasonable compensation only.

viii. Forfeiture of Security Deposit (or Earnest Money):
A clause in a contract which provides for forfeiture of security deposit in the event of failure to perform is in the nature of a penalty. In such cases, the court may award reasonable compensation only.

III. Suit for Specific Performance:
Suit for specific performance means demanding the court's direction to the defaulting party to carry out the promise according to the terms of the contract.

Example: X agreed to sell an old painting to Y for Rs 50,000. Subsequently, X refused to sell the painting. Here, Y may file a suit against X for the specific performance of the contract.

Cases where suit for specific performance is not maintainable.

a. Where the damages are considered as an adequate remedy.

b. Where the contract is of personal nature, e.g. contract to marry.

c. Where the contract is made by a company beyond its powers as laid down in its Memorandum of Association.

d. Where the court cannot supervise the performance of the contract.

e. Where one of the parties is a minor.

f. Where the contract is inequitable to either party.

IV. Suit for Injunction:
Suit for injunction means demanding court's stay order. Injunction means an order of the court which prohibits a person to do a particular act. Where a party to a contract does something which he promised not to do, the court may issue an order prohibiting him from doing so.

V. Suit for Quantum Meruit:
Quantum Meruit means as much as is earned. Right to Quantum Meruit means a right to claim the compensation for the work already done.

Example: C an owner of a magazine engaged P to write a book to be published by instalments in his magazine. After a few instalments were published, the publication of the magazine was stopped. It was held that P could claim payment for the part already published [Planche vs. Calburn].

Check your progress – 9:

What are the remedies for breach of contract?

LESSON-10

INDEMNITY AND GUARANTEE

CONTENTS

1.10.1 Contract of Indemnity
1.10.2 Contracts of Guarantee
Check your progress: 10

The contract of Indemnity and Contract of Guarantee are specific types of contracts. The specific provisions relating to these contracts are contained in Secc124 to 147 of the Indian Contract Act, 1872. In addition to these specific provisions, the general principles of contracts are also applicable to such specific contracts.

1.10.1 CONTRACT OF INDEMNITY

'Indemnity' means to make good the loss or to compensate the party who suffered some loss.

Meaning of Contract of Indemnity [Section 124]
A contract by which one party promises to save the other from loss caused to him conduct of the promisor himself, or by the conduct of any other person, is a 'contract of indemnity'.

Example: A contracts to indemnify B against the consequences of any proceedings which C may take against B in respect of a certain sum of Rs 2,00,000. This is a contract of indemnity.

Meaning of Indemnifier :
The person who promises to make good the loss is called the 'indemnifier'. In the example, A is the indemnifier.

Meaning of Indemnity-Holder

The person whose loss is to be made good is called 'indemnity-holder'. In the example, B is the indemnity-holder.

Whether Contract of Indemnity Covers the Cases of Loss Caused by the Events or Accidents which do not Depend upon the Conduct of the Promisor or other Person:

If the definition of contract of indemnity as per Section 124 is strictly interpreted, it would not cover the cases of loss caused by the events or accidents which do depend upon the

conduct of the promisor or any other person. In other words, contracts of insurance would be outside the purview of the contract of indemnity.

Since the intention of law makers had never been to exclude the contracts of insurance from the purview of contracts of indemnity, the courts in India have decided to apply the same equitable principles that the courts in England do. As English law, a contract of indemnity is defined as 'a promise to save another less from loss caused as a result of a transaction entered into at the instance of promisor.' This definition covers a promise to make good the loss arising from any cause whatsoever.

Thus, Indian courts follow the English law in respect of contract of indemnity which covers the contracts of insurance also.

Rights of Indemnity-holder:

An indemnity holder is entitled to recover the following amounts from the indemnifier provided he acts within the scope of his authority.

1. All damages which he may be compelled to pay in any suit in respect of matter to which the promise to indemnify applies;
2. All costs which he may be compelled to pay, in bringing or defending suit if, he did not contravene the orders of the promisor, and acted as would have been prudent for him to act in the absence of any contract indemnity, or if the promisor authorized him to bring or defend the suit.
3. All sums which he may have paid under the terms of any compromise of such suit, if the compromise was not contrary to the orders of the promisor and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promisor authorized him to compromise the suit.

Modes of Contract of Indemnity

A contract of indemnity may be express or implied.

a. A contract of indemnity is said to be express when a person expressly promises to compensate the other from loss.
b. A contract of indemnity is said to be implied when it is to be inferred from the conduct of the parties or from the circumstances of the case.

Essential Elements of Contract of Indemnity:

In addition to the implied or express promise to indemnify, all the essentials of a contract must also be present.

1.10.2 CONTRACTS OF GUARANTEE

Meaning of a Contract of Guarantee [Section 126]

A contract of guarantee is a contract to perform a promise or discharge the liability of a third person in case of his default.

Example: X and his friend Y enter a shop and X says to Z "Supply the goods required by Y and if he does not pay you, I will." It is a contract of guarantee.

Parties to a contract of Guarantee:

There are three parties to a contract of guarantee.

Principal Debtor [Section 126]:

The person in respect of whose default the guarantee is given is called the 'Principal debtor'. Y is the principal in the aforesaid example.

Creditor [Section 126]:

The person, to whom the guarantee is given, is called the 'creditor'. Z is the creditor in the aforesaid example.

Surety [Section 126]:

The person who gives the guarantee is called 'Surety'. X is the surety in the aforesaid example.

Essential Features of a contract of guarantee:

1. Tripartite Agreement:

   A contract of guarantee is a tripartite agreement between the principal debtor, creditor and surety.

2. Consent of Three Parties:

   There must be consent of all the three parties.

3. Existence of a Liability:

   There must be an existing liability or a promise whose performance is guaranteed. Such liability or promise must be enforceable by law. Hence, guarantee can be given only for liability or promise which is enforceable by law. But there is an exception to this rule. The exception is a g given for minor's debt. Though minor's debt is not enforceable by law, yet the guarantee given for minor's debt is valid.

4. Essentials of a Valid Contract:

   All the essentials of a valid contract must be present in a contract of guarantee.

5. Guarantee not to be Obtained by Misrepresentation [Section 142]:

   Any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid.

6. Guarantee not to be Obtained by Concealment [Section 143];

   Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid.

Basis	*Contract of indemnity*	*Contract of guarantee*
1. No. of parties	There are two parties- indemnifier and the indemnity-holder.	There are three parties- principal debtor, creditor and surety.
2. No. of contracts	There is only one contract between indemnifier and indemnity-holder.	There are three contracts, one between creditor and principal debtor, second between surety and principal debtor, and the third between surety and the creditor.
3. Undertaking	The indemnifier undertakes to save the indemnity-holder from any loss.	The surety undertakes for payment of debts of principal debtor.
4. Nature of liability	The liability of indemnifier is primary and unconditional.	The liability of surety is secondary and conditional. Surety' liability is secondary in the sense that the primary liability is principal debtor. Surety's liability is conditional in the sense it arises only on default of principal debtor.
5.Nature of event	The liability arises only on the happening of a contingency.	The liability arises only on the non-performance of an existing promise or non-payment of existing debt.
6.Request	The indemnifier need not act at the request of indemnity-holder.	The surety acts at the request of the principal debtor.

7.Right to sue	The indemnifier cannot sue a third party in his own name because of absence of privity of contract between him and a third party. He can sue the third party in his own name if there is an assignment in his favour.	A surety, on discharging the debt of principal debtor, can sue principal debtor in his own name.

Check your progress – 10:

What are contracts of indemnity and guarantee?

LESSON-11

BAILMENT AND PLEDGE

CONTENTS

1.11.1 Meaning of Bailment

1.11.2 Pledge

Check your progress: 11

Indian Contract Act, 1872 deals with the general rules relating to bailment but not with all types of bailment for which separate acts have been enacted, for example, The Carrier Act 1865, The Railways Act, 1890, The Carriage of Goods by Sea Act, 1925.

1.11.1 MEANING OF BAILMENT

The word 'Bailment' is derived from a French word 'baillier' which means 'to deliver'. According to Section 148, a "bailment" is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them.

Explanation:
If a person already in possession of the goods of another contracts to hold them as a bailee, he thereby becomes the bailee, and the owner becomes the bailor of such goods, although they may not have been delivered by way of bailment.

The person delivering the goods is called the 'bailor'.

The person to whom the goods are delivered is called the 'bailee'.

Examples of bailment:

1. X who is going out of station delivers a horse to Y for proper care.
2. X lends a horse to Y for his riding only without charge.
3. Y hires a horse from X for riding.
4. X delivers a horse to a doctor, Y, for medical treatment.
5. X sells a horse to Y who leaves the horse in the possession of X.

Essential elements of a Bailment:

1. Agreement:

   There must be an agreement between the bailor and the bailee. This agreement may be either express or implied. However, a bailment may be implied by law also. For example, bailment between a finder of goods and owner of goods.

2. Delivery of Goods:

   There must be delivery of goods. It means that possession of goods must be transferred.

a. The delivery must be voluntary; for example, the delivery of jewellery its owner to a thief who shows a revolver, does not create a bailment because the delivery is not voluntary.

b. Delivery may be actual or constructive.
   Actual Delivery:
   A delivery is said to be actual where the goods are physically handed over by one person to another. For example, delivery of a car for repairs a workshop dealer.
   Constructive Delivery [Section 149]:
   A delivery is said to be constructive when it is made by doing anything which has the effect of putting goods in the possession of the intended bailee or of any person authorized to hold them on his behalf. For example, delivery of the key of a car to a workshop dealer for the repair of the car.

3. Purpose:
   The delivery of goods must be for some intended purpose. For example, wrong delivery of goods to Jaipur Golden Roadways instead of Patel Roadways, does not create any bailment.

4. Return of Specific Goods:
   The goods which form the subject matter of bailment must be returned to the bailor or otherwise disposed off according to directions of the bailor, after the accomplishment of purpose or after the expiry period of the bailment. It may be noted that the same goods (which were delivered by bailor to bailee) must be returned in their original form or desired form (if any required by the bailor). Thus, the goods must be retured in specie (same) though they may undergo a change in form.

1.11.2 PLEDGE

Meaning of Pledge (or Pawn) [Section 172]

The bailment of goods as security for payment of a debt or performance of a promise is called pledge (or pawn).

Example: X borrows Rs 1,00,000 from Citi Bank and keeps his shares as security for payment of a debt. It is a contract of pledge.

Meaning of a Pawnor (or Pledgor) [Section 172]

The person who delivers the goods as security for payment of a debt or performance of a promise is called the Pawnor or Pledgor. In the aforesaid example, X is the pawnor.

Meaning of Pawnee (or Pledgee) [Section 172]

The person to whom the goods are delivered as security for payment of a debt or performance of a promise is called the Pawnee or Pledgee. In the aforesaid example, Citi Bank is the pawnee.

Special Feature of Pledge:

It is the special property in goods and not the general property in goods, which passes to the pledgee. General property means the ownership of goods and special property means the possession of goods.

Example: A producer of a film borrowed Rs 10,00,000 from a financier-distributor and agreed deliver the final prints of the film when ready. This agreement was not a pledge because there was no actual transfer of possession. [Revenue Authority vs. Sudarshan Pictures]

Distinction between Pledge and Bailment:

Basis of distinction	Pledge	Bailment
I. Purpose	Pledge is bailment of goods for a specific purpose, i.e. repayment of a debt or performance of a duty.	Bailment is for a purpose of any kind.
III. Right to use	Pawnee cannot use the goods pledged.	Bailee can use the goods as per terms of bailment.
IV. Right to sell	Pawnee can sell the goods pledged after giving notice to the pawnor in case of default by the pawnor.	Bailee can either retain the goods or sue the bailor for his dues.

Check your progress – 11:

Define bailment and pledge.

LESSON-12

CONTRACT OF AGENCY

CONTENTS

1.12.1 Contract of Agency
1.12.2 Essentials of relationship of agency
1.12.3 Rules of Agency
1.12.4 Test of Agency
Check your progress: 12

AIMS AND OBJECTIVES

On reading this unit, you will be able to

i. Understand the concepts of agency, agents and principal
ii. Analyse the need for contract of agency
iii. Differentiate between the various types of agents
iv. Have an idea about the rights and duties of agents
v. Discuss the methods by which agency relationships can be established

INTRODUCTION

Since it is not always possible for a person to do everything by himself, it becomes necessary to delegate some of the acts to be performed by another person. Such another person is called an agent. The person represented is called the principal.

1.12.1 CONTRACT OF AGENCY

The law relating to agency is contained in Chapter X (Sections 182 to 238) of the Indian Contract Act, 1872.

Definition of Agent and Principal

AGENT

Meaning of an Agent (Section 182):

An agent is a person employed to do any act for another person or to represent another person in dealings with third persons. Thus, an agent establishes a contract between such another person and third person.

Who may be an Agent (Section 184):

As between the principal and third persons, any person (whether he has contractual capacity or not) may become an agent. Thus, a minor or person of unsound mind can also become an agent.

Agent's responsibility to his Principal:

An agent who is not of the age of majority and of sound mind is not responsible to his principal.

Example: X hands over to Y, a minor, a TV set worth Rs.18,500 and instructs him not to sell it for below Rs.19,000. Y sells the same to Z for Rs.18,000. X will be responsible to Z for the act of Y, but Y himself will not be responsible to X since he has no contractual capacity.

PRINCIPAL

Meaning of Principal (Section 182):

The person for whom act is done by an agent or who is represented in dealings with third persons by an agent is called the Principal.

Who may employ Agent (Section 183):

Any person who is of the age of majority according to the law to which he is subject, and who is of sound mind, may employ an agent. Thus, a minor or a person of unsound mind cannot appoint an agent. It has been held that a guardian of a minor can appoint an agent to minor. [Madan Lal Vs. Bheru Lal].

1.12.2: ESSENTIALS OF RELATIONSHIP OF AGENCY

Following are the essentials of the relationship of agency:

1. Agreement between the principal and the agent:
   Agency depends on agreement but not necessarily on contract. As between the principal and third persons, any person may become an agent (Sec.184). As such, even a minor or a person of unsound mind can be an agent. The principal is, however, liable for the acts of such an agent.

2. No consideration necessary:
   No consideration is necessary to create an agency (Sec.185). The fact that the principal has agreed to be represented by the agent is sufficient.

3. Intention of the agent to act on behalf of the principal:
   Whether a person does intend to act on behalf of another is a question of fact. Where a person does intend to act on behalf of another person, agency may arise, although the contract between the parties provides that there is no such relationship.

1.12.3 RULES OF AGENCY

There are two important rules of an agency:

1. Whatever a person can do personally, he can do through an agent:
   This rule is of course subject to certain well-known exceptions as when the act to be performed is personal in character. Eg. The principal cannot ask his agent to become insolvent on his behalf or to marry on his behalf.

2. He who does an act through another does it by himself:
   What a person does by another, he does by himself. Thus, the acts of the agent are the acts of the principal.

1.12.4 TEST OF AGENCY

The true test of agency lies in answering the question whether a person has the capacity to create contractual relationship between the principal and a third party and to bind the principal by his acts. If the answer to this question is yes, there exists the relationship of agency, otherwise not.

Check your progress – 12:

What do you understand by contract of agency?

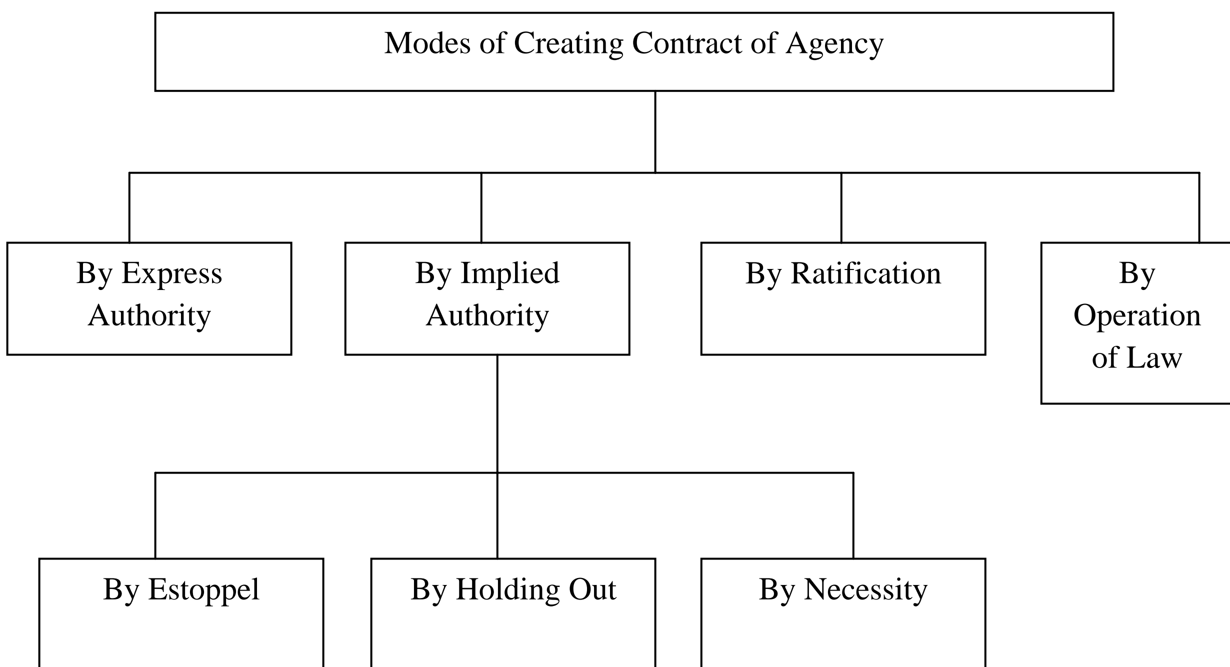
LESSON-13
CREATION OF AGENCY

CONTENTS

1.13.1 Modes of creation of agency
Check your progress: 13

1.13.1 MODES OF CREATION OF AGENCY

The various modes to create the contract of agency are shown below:



I.Agency by Express Authority (Sections 186 and 187)
An agency by express authority is created when an express authority is given to the agent by spoken or written words.
Example: X owns a shop, appoints Y to manage his shop by executing a power of attorney in Y's favour. Here, the relationship of principal and agent has been created between X and Y by an express authority.
II.Agency by Implied Authority (Section 187)
An agency which has to be understood from the conduct and behaviour of the parties is called implied agency. It is to be inferred from the circumstances of the case and things

spoken or written, or the ordinary course of dealing may be accounted as circumstances of the case.

Example: A owns a shop in Ooty, but he lives in Chennai. He visits his shop occasionally. The shop is managed by B, and he is in the habit of ordering goods from C in the name of A for the purposes of the shop and of paying for them out of A's funds with A's knowledge. B has an implied authority from A to order goods from C in the name of A for the purposes of the shop.

Implied agency includes the following:
Agency by Estoppel:
Agency by estoppel arises where a person by his words or conduct induces third persons to believe that a certain person is his agent. The person who induces as such is stopped or prevented from denying the truth of agency. Section 237 of the Act deals with agency by estoppel.

Example: X tells Y, in the presence and within the hearing of Z that he (X) is Z's agent. Z does not say anything against this statement. Later on Y enters into a contract with X believing that X is Z's agent. In such a case, Z is bound by this contract and in a suit (case) between Z and Y, Z cannot be permitted to say that X was not his agent, even though X was not actually his agent.

Agency by Holding Out:
Agency by holding out is almost similar to agency by estoppel. Such agency arises when a person by his past affirmative or positive conduct makes third person to believe that person doing some act on his behalf is doing with authority.
Example: X allows Y, his servant to purchase goods for him on credit from Z and later on pays for them. One day X pays cash to Y to purchase goods. Y keeps the money and purchases goods on credit from Z. Z can recover the price of his goods from X because X had held out Z as his agent on earlier occasions.

Agency by Necessity:
Agency by necessity arises under the following two conditions:
There is an actual and definite necessary for acting on behalf of the principal, and
It is impossible to communicate with the principal and get his consent
The act must have been done for the benefit of the principal.

Example I : X consigned some vegetables from Deli to Mumbai by a truck. The truck met with an accident. The vegetables, being perishable were sold by the transporter. This sale is binding on X. In this case, the transporter became an agent by necessity. [Sim & Co. Vs. Midland Railway Co.]

Example II : X stored some furniture in Y's house free of charge. After three years, Y needed the space occupied by the furniture. He obtained X's address from is bank and wrote two letters to him but he received no reply. Y then sold the furniture. It was held

that the sale was not binding on the owner because there was no emergency which required the sale of furniture. [Sachs Vs. Mikos]

III.Agency by Ratification (Section 196)
A person may act on behalf of another person without his knowledge or consent. For example, A may act as P's agent though he has no prior authority from P. In such a case, P may subsequently either accept the act of A or reject it. If he accepts the act of A, done without his consent, he is said to have ratified that act and it places the parties in exactly the same position in which they would have been if A had P's authority at the time he made the contract. Likewise, when an agent exceeds the authority given to him by the principal, the principal may ratify the unauthorised act.

Thus, when the principal approves an act of the agent who never had the authority to undertake such an act, it is called Ratification.
Ratification may be express or may be implied by the conduct of the person on whose behalf the acts are done.
Ratification relates back to the date when the act was done by the agent.
Example: A insures P's goods without his authority. If P ratifies A's act, the policy will be as valid as if A had been authorised to insure the goods [Williams Vs. North China Insurance Co., (18760]

Requisites of a valid ratification:

1. No valid ratification can be made by a person whose knowledge of the facts of the case is materially defective.

2. The ratification must be made for the whole transaction and not for a part of transaction. When a person ratifies a part of the unauthorised transaction, it is treated as the ratification of the whole transaction.

3. An act which has the effect of subjecting a third person to damages or of terminating any right or interest of a third person cannot be ratified.

4. The acts done by the agent on behalf of another person can only be ratified. Thus, the acts done by the agent in his own name cannot be ratified.

5. The principal must be in existence at the time when the act is done in his name.

6. The principal must have contractual capacity both at the time of contract and at the time of ratification.

7. The ratification must be done within a reasonable time, otherwise it will not be binding.

8. Only those acts which are lawful can be ratified.

9. Only those acts which are within the principal's power can be ratified. Thus, an act which is beyond the competence of a principal cannot be ratified.

10. The ratification must be communicated to the third party so as to be binding on the third party.

IV.Agency by Operation of Law:
Agency by operation of law is said to arise where the law treats one person as an agent of another.
Example: On formation of a partnership, every partner becomes the agent of other partner. Such agency is said to be arisen by operation of law.
When a company is formed, its promoters are its agents by operation of law.

Check your progress – 13:

Explain the modes by which agencies can be created.

LESSON-14
CLASSIFICATION OF AGENTS

CONTENTS

1.14.1 General classification of agents
Check your progress: 14

1.14.1 GENERAL CLASSIFICATION OF AGENTS

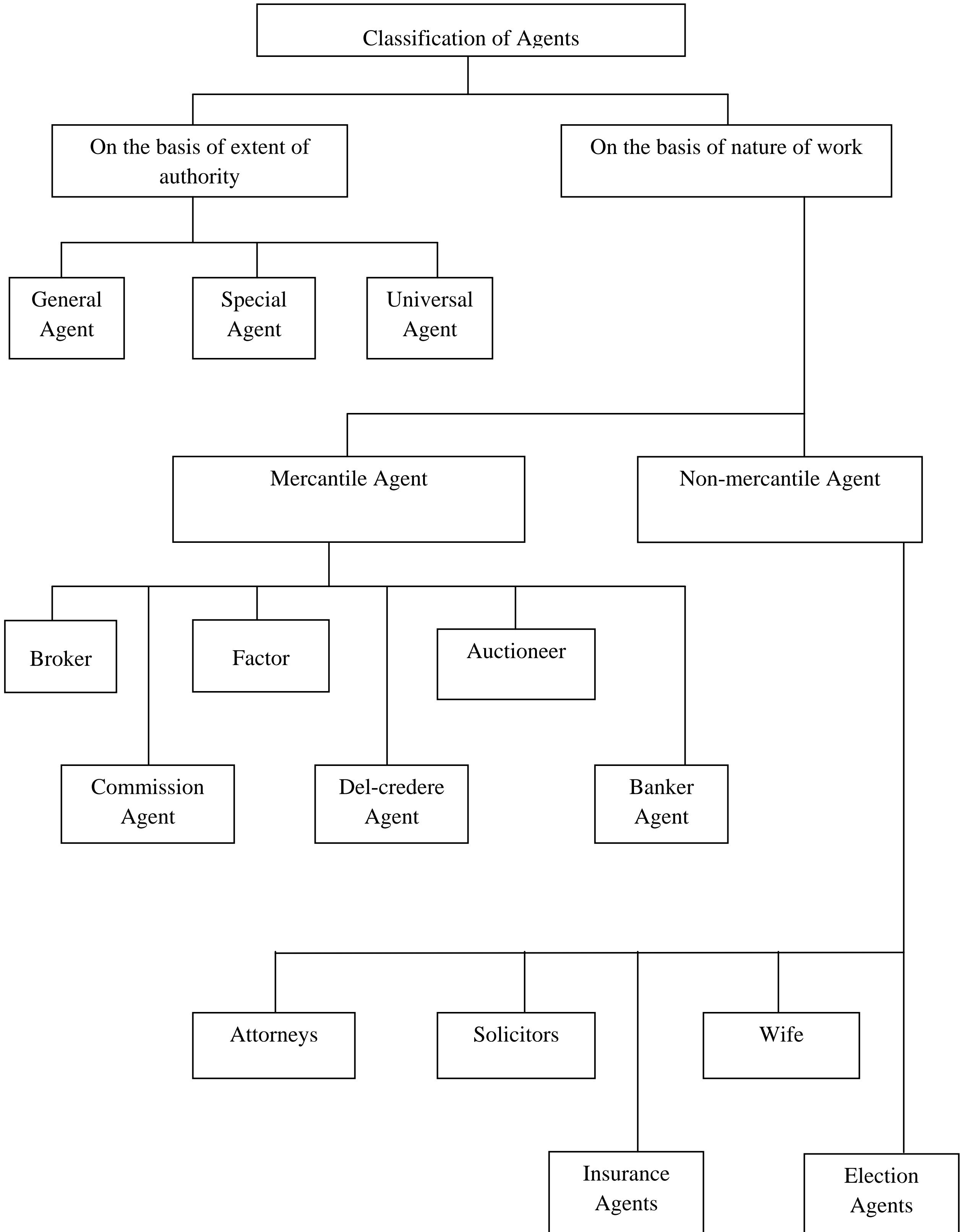
A general classification of agents from the point of view of the extent of their authority is as follows:

1. **Special Agent**: A special agent is one who is appointed to perform a particular act or to represent his principal in some particular transaction as, for example, an agent employed to sell a house or an agent employed to bid at an auction. Such an agent has a limited authority and as soon as the act is performed, his authority comes to an end. He cannot bind his principal in any matter other than that for which he is employed. The persons who deal with him are bound to ascertain the extent of his authority.

2. **General Agent**: A general agent is one who has authority to do all acts connected with a particular trade, business or employment. For example, the manager (general agent) of a firm has an implied authority to bind his principal by doing anything necessary for carrying on the business of the firm or which falls within the ordinary scope of the business. Such authority of the agent is continuous until it is put to an end. If the principal, by secret instructions, limits the authority of the general agent, and the agent exceeds the authority, the principal is bound by the agent's acts done within the scope of his authority, unless the third parties dealing with the agent have a notice of the curtailment of the authority of the agent.

3. **Universal Agent**: A universal agent is one whose authority to act for the principal is unlimited. He has authority to bind his principal by any act which he does, provide that act
   i. Is legal
   ii. Is agreeable to the law of the land.

Classification of Agents:



I. Commercial or Mercantile Agents:

A 'Mercantile agent', according to Sec.2 (9) of the Sale of Goods Act, 1930, means a "mercantile agent having in the customary course of business as such agent, authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods".

a. Factor: A factor is a mercantile agent entrusted with the possession of goods and who has the authority to buy, sell or otherwise deal with the goods or to raise money on their security. He has general lien on the goods.

b. Broker: A broker is one who negotiates and makes contracts between the principal and the third party. He is not entrusted with the possession of goods and hence he has no lien on the goods.

c. Auctioneer: An auctioneer is one who is entrusted with the possession of goods for sale at a public auction. He has only a particular lien on the goods for his charges.

d. Commission Agent: The term 'commission agent' is a general term which is used in practice even for a factor or broker. He is employed to buy and sell goods, or transact business generally for other person receiving for his labour and trouble a money payment, called commission.

e. Del-credere Agent: A del-credere agent is one who gives guarantee to his principal to the effect that the third person with whom he enters into contracts shall perform his obligation. He gives such guarantee for an extra remuneration which is called the Del-credere Commission. For example, an agent who also undertakes the risk of bad debts due to the insolvency of customers to whom the goods were sold on credit will be called the del-credere agent.

f. Banker: Banker acts as an agent of the customer when he collects cheques or drafts or bills or buys or sells securities on behalf of his customers. He has a general lien in respect of the general balance of account.

II. Non-Mercantile Agents:

These include attorneys, solicitors, insurance agents, election agents, clearing and forwarding agents and wife. etc.

Check your progress – 14:

Write about types of agents

LESSON-15

EXTENT OF AGENT'S AUTHORITY

CONTENTS

1.15. 1 Agent's authority
1.15. 2 Extent of agent's authority
1.15. 3 Delegation of authority of agent
Check your progress: 15

1.15.1 AGENT'S AUTHORITY

An agent's authority means the capacity of the agent to bind his principal. The authority of the agent to bind the principal may be-

a. Actual or Real Authority, or

b. Ostensible or Apparent Authority

a. Actual or Real Authority
Actual Authority of an agent is the authority conferred on him by the principal. It may be expressed or implied (Sec.186)
Express Authority: Authority is said to be express when it is given by words spoken or written (Sec.187)
An authority is said to be Implied when it is to be inferred from the circumstances of the case; and things spoken or written r the ordinary course of dealing may be accounted circumstances of the case (Sec.187)

b. Ostensible or Apparent Authority
When an agent is employed for a particular business, persons dealing with him can presume that he has authority to do all such acts as are necessary or incidental to such business. Such authority of the agent is called ostensible or apparent authority as distinguished from actual or real authority. The scope of an agent's authority is determined by his ostensible authority. If the act of

Extent of agent's authority means the scope of authority of an agent. In other words, it means what a person can do as an agent on behalf of his principal. Extent of agent's authority may be discussed under normal circumstances and emergency circumstances.

1.15.2 EXTENT OF AGENT'S AUTHORITY

Extent of Agent's Authority under Normal Circumstances (Section 188)

An agent having an authority to do an act has authority to do every lawful thing which is necessary in order to do such act. An agent having an authority to carry on a business has authority to do every lawful thing necessary for the purpose or usually done in the course of conducting such business.

Example: A appoints B, his agent to carry on his business of a ship-builder. B may purchase timber and other materials, and hire workmen for the purpose of carrying on the business.

Extent of Agent's Authority in Emergency (Section 189)

An agent has authority, in an emergency, to do all such acts for the purpose of protecting his principal from loss as would be done by a person of ordinary prudence, in his own case, under similar circumstances.

Example: Where butter was in danger of becoming useless owing to delay in transit and it was impossible to obtain instructions of the principal, the railway company sold the butter for the best available price. It was held that the principal was bound by this sale. [Sim & Co. Vs. Midland Rail Co.]

1.15.3 DELEGATION OF AUTHORITY OF AGENT

The general rule is that an agent is not entitled to delegate his authority to another person without the consent of his principal. 'Delegatus non potest delegare' is the maxim which means that a person to whom authority has been given, cannot delegate that authority to another. Sec.190 also prohibits delegation of such authority. This is because when the principal appoints a particular agent to act on his behalf, he relies upon the agent's skill, integrity and competence.

Sub-agent:

A 'Sub-agent' is a person employed by, and acting under the control of, the original agent in the business of the agency (Sec.191). This means he is an agent of the original agent. The relation of the sub-agent to the original agent is, as between themselves, that of the agent and principal.

Exceptions:

Sec.190 provides that an agent may appoint a sub-agent and delegate the work to him if-

i. There is a custom of trade to that effect, (eg. Article clerks employed by a Chartered Accountant) or
ii. The nature of work is such that a sub-agent is necessary.

There are some more exceptions recognised by the English law. These exceptions are also recognised in India and are as follows:

iii. Where the principal is aware of the intention of the agent to appoint a sub-agent but does not object to it.
iv. Where unforeseen emergencies arise rendering appointment of a sub-agent necessary.
v. Where the act to be done is purely ministerial not involving confidence or use of discretion.
vi. Where the principal permits appointment of a sub-agent.
vii. Where the duties of the agent do not require any personalised skill, confidence or discretion and the work involved is of routine nature.

Relationship between principal and sub-agent: As a general rule, an agent cannot delegate his authority to a sub-agent. But in certain exceptional cases, he is permitted to do so. In such cases, the delegation of authority to a sub-agent is proper. In all other cases, the appointment of a sub-agent is improper. The legal relation between the principal and the sub-agent depends upon the crucial question, as to whether the appointment of the sub-agent is proper or improper.).

Co-agent or Substituted agent

A Co-agent or a substituted agent is a person who is named by the agent, on an express or implied authority from the principal, to act for the principal. He is not a sub-agent but an agent of the principal for such part of the business of the agency as is entrusted to him. He is the agent of the principal, though he is named, at the request of the principal, by the agent (Sec.194).

In selecting a co-agent for his principal an agent is bound to exercise the same amount of discretion as a man of ordinary prudence would exercise in his own case; and if he does this, he is not responsible to the principal for the acts or negligence of the co-agent (Sec.195).

Check your progress – 15:

Who are co-agents and sub-agents?

LESSON-16
POSITION OF PRINCIPAL AND AGENT IN RELATION TO THIRD PARTIES

CONTENTS

1.16. 1 Position of principal and agent in relation to third parties
1.16. 2 Personal liability of agents
1.16. 3 Rights of an agent
1.16. 4 Duties of an agent
Check your progress: 16

1.16.1 POSITION OF PRINCIPAL AND AGENT IN RELATION TO THIRD PARTIES

The position of a principal and his agent as regards contracts made by the agent with third parties may be discussed under the following three heads:

1. Where the principal's existence and name are disclosed by the agent, ie., where the principal is named
2. Where the principal's existence is disclosed but not his name, ie., where the principal is unnamed
3. Where both the existence and the name of the principal are not disclosed, ie., where the principal is undisclosed.

I. Named Principal:

The position of the named principal for the acts of his agent is as follows:

i. Acts of the agent are the acts of the principal:

The principal is liable for the acts of the agent with third persons provided his acts are done

a. Within the scope of his authority, and
b. In the course of his employment as an agent

He is also liable for such acts of the agent which are necessary for the proper execution of his (agent's) authority. Sec.226 further provides that contracts entered into through an agent, and obligations arising from acts done by an agent may be enforced in the same manner and will have the same legal consequences, as if the contracts had been entered into and the acts done by the principal.

Example: A is P's agent with authority to receive money on his behalf. He receives from T a sum of money due to P. T is discharged of his obligation to pay the sum in question to P.

ii. *When the agent exceeds his authority:*

When an agent exceeds his authority to do work of the principal, the principal is bound by that part of the work which is within his authority and which can be separated from the part which is beyond his authority (Sec.227)

Where an agent exceeds his authority, the principal may repudiate the whole of the transaction if what he (the agent) does beyond the scope of his authority cannot be separated from the rest (Sec.228)

iii. Notice given to agent as notice to principal:

The principal is bound by the notice given to or information obtained by the agent in course of the business of the principal (Sec.229). The principal is also bound by the admissions made by the agent.

But where the agent has committed a fraud on his principal, any information obtained by him or notice given to him is not regarded as having been obtained by the principal. In such cases the knowledge of the agent is not imputed to the principal because of the extreme improbability of the agent communicating his fraud to the principal. [Cave vs. Cave, (1880) 15 Ch. D. 630]

iv. *Principal inducing belief that agent's unauthorised acts were authorised:*

Where a person by his conduct, or by words spoken or written leads wilfully another person to believe that a certain state of affairs exists and induces him to act on that belief so as to alter his previous position, he is prohibited from denying subsequently the fact of that state of affairs [Pickard vs. Sears, (1837) 6 A. & E. 474].

v. Misrepresentation or fraud of agent:

The principal is liable for the misrepresentations made or frauds committed by the agent in the course of his business for the principal. Such misrepresentations or frauds have the same effect on agreements made by such agent as if these had been made or committed by the principal. However, misrepresentations made or frauds committed by the agent in matters, which do not fall within his authority, do not affect his principal. (Sec. 238).

II. Unnamed Principal:

When an agent contracts as an agent for a principal but does not disclose his name, the principal is liable for the contract of the agent, unless there is a trade custom or a term, express or implied, to the effect which makes the agent personally liable. If the third party

contracts knowing that there is a principal although his identity is not disclosed, he cannot sue the agent. If, however, the agent declines to disclose the identity of the principal, he will become personally liable on the contract.

III. Undisclosed Principal:

Sometimes, an agent not only conceals the name of the principal but also the fact that he is an agent. This gives rise to *the doctrine of undisclosed principal*. The agent in such case gives an impression to the third party as if he is contracting in an independent capacity.

Sec. 231 deals with rights of parties to a contract made by an agent for the undisclosed principal. The position of parties to such a contract may be discussed under the following heads:

a. The position of principal:

When an undisclosed principal is subsequently discovered or he himself intervenes, the other contracting party (if he has not already obtained judgment against the agent) may sue either the principal or the agent or both. The principal may also if he likes, require the performance of the contract from the other contracting party. But in such a case he must allow to the third party the benefit of all payments made by the third party to the agent.

b. The position of agent:

As between the principal and the agent, the agent has all the rights of an agent as against the principal; but as regards the third party, he is personally liable on the contract. He may be sued on the contract and he has the right to sue the third party.

c. The position of third parties:

i. In a contract with an agent for an undisclosed principal, the third party may elect to sue either the principal or the agent or both.

ii. If the principal discloses himself before the contract is completed, the other contracting party may refuse to fulfil the contract, if he can show that, if he had known who the principal was or that the agent was not the principal, he would not have entered into the contract (Sec. 231).

iii. The third party can also claim a right of set-off against the agent. Where the principal requires the performance of the contract, he can only obtain such performance as is subject to the rights and obligations subsisting between the agent and the other party to the contract (Sec. 232).

Liability of Pretended Agent

A person may sometimes untruly represent himself to be the authorised agent of another, and thereby induce a third person to deal with him as such agent. He is, in such a case, liable, if his alleged employer does not ratify his acts, to make compensation to the third person in respect of any loss or damage which he has incurred by so dealing (Sec. 235).

While the third person has the right to claim compensation from the pretended agent, the agent has no right to proceed against that person for the contract. Thus, a person with whom a contract has been entered into in the character of agent is not entitled to require the performance of it, if he was in reality acting, not as agent, but on his own account (Sec. 236).

1.16.2 PERSONAL LIABILITY OF AGENT

The general rule is that only the principal can enforce, and can be held liable on, a contract entered into by the agent except when there is a contract to the contrary.

General Rule [Section 230]

In the absence of any contract to that effect, an agent cannot personally enforce contract entered into by him on behalf of his principal, not is he personally bound by them.

When the agent becomes personally liable:

The circumstances under which an agent becomes personally liable are as follows:

a. In case of foreign principal:
Where the contract is made by an agent for the sale or purchase of goods for a merchant residing abroad, in the absence of any contract to the contrary, it is presumed that the agent is personally liable for such contracts.

b. In case of undisclosed principal:
Where the contract is made by an agent for an undisclosed principal, in the absence of any contract to the contrary, it is presumed that the agent is personally liable.

c. In case of incompetent principal:
Where a contract is made by an agent for a person who cannot be sued (e.g. minor, lunatic, foreign ambassador), in the absence of any contract to the contrary, it is presumed that the agent is personally liable.

d. In case of principal not in existence:
Where a contract is made by the promoter for a company not yet incorporated, the promoters are personally liable.

e. In case of act not ratified:
A person untruly representing himself to be the authorised agent of another, and thereby inducing a third person to deal with him as such agent, is liable, if his alleged employer does not ratify his acts, to make compensation to the other in respect of any loss or damage which he has incurred by so dealing.

f. In case of acts in his own name:
   Where a contract is made by an agent without disclosing that he is contracting as an agent, the agent is personally liable.

g. In case of express agreement:
   Where a contract made by an agent specifically provides for the personal liability of the agent, the agent will be personally liable.

h. In case of custom or usage of trade:
   Where there is a custom or usage of trade making the agent personally liable, in the absence of any contract to the contrary, the agent is personally liable.

1.16.3 RIGHTS OF AN AGENT

The rights of an agent are as follows:

a. Right of Retainer [Section 217]

An agent has the right to retain, out of any sum received on account of the principal in the business of the agency, all money due to himself in respect of the following:

i. Advance made by him
ii. Expenses properly incurred by him in conducting such business.
iii. Such remuneration as may be payable to him for acting as an agent
b. Right to receive remuneration [Section 219 to 220]

The agent has the right to receive agreed remuneration (if there is an agreement to that effect) or usual remuneration as per the custom of the trade in which he has been employed (if there is not agreement to that effect)

c. Right of Lien [Section 221]

In the absence of any contract to contrary, an agent is entitled to retain goods, papers and other property whether movable or immovable, of the principal received by him, until the amount due to him for commission, disbursement and services in respect of the same has been paid or accounted for to him. Thus, this right of lien arises-

i. Only if there is no contract to the contrary
ii. Only in respect of those properties the possession of which has been lawfully acquired by the agent
iii. Only in respect of those properties in respect of which some amount is due to the agent

Thus, this lien is only a particular lien.

d. Right to be indemnified against consequences of lawful acts [Section 222]

The employer of an agent is bound to indemnify him against the consequences of all lawful acts done by such agent in exercise of the authority conferred upon him.

e. Right to be indemnified against consequences of acts done in good faith [Section 223]

Where one person employs another to do an act, and the agent does the act in good faith, the employer is liable to indemnify the agent against the consequences of that act, though it causes an injury to the rights of third person.

f. Right to receive compensation for injury caused by principal's neglect [Section 225]

The principal must make compensation to his agent in respect of injury caused to such agent by the principal's neglect or want of skill.

1.16.4 DUTIES OF AN AGENT

The various duties of an agent are as follows:

An agent owes a number of duties to his principal which varies in degree according to the nature of agency. These duties are as follows:

1. To carry out the work undertaken according to the directions given by the principal:

   In the absence of any such directions, he must acct according to the custom which prevails in doing business of the same kind at the place where he conducts such business. When he acts otherwise, if any loss be sustained, he must make it good to his principal, and, if any profit accrues, he must account for it [Sec.211]. If the agent's disobedience is material, the principal may even terminate the agency.

2. To carry out the work with reasonable care, skill and diligence:

   An agent is bound to conduct the business of the agency with as much skill as is generally possessed by persons engaged in similar business, unless the principal has notice if his want of skill. He is always bound to act with reasonable diligence, to use skill as he possesses, and to make compensation to his principal in respect of the direct consequence of his neglect, want of skill or misconduct. But he is not liable to his principal in respect of loss or damage which indirectly or remotely caused by such neglect, want of skill or misconduct [Sec. 212]

3. To render proper accounts to his principal:

4. An agent is bound to render proper accounts to his principal on demand. [Sec. 213]

5. To communicate with the principal in case of difficulty:

   It is the duty of an agent, in cases of difficulty, to use all reasonable diligence in communicating with his principal and in seeking to obtain his instructions [Sec. 214]

6. Not to deal on his own account:

   An agent must not deal on his own account in the business of the agency without first obtaining the consent of the principal and acquainting him with all the material circumstances which have come to his knowledge.

7. To pay sums received for the principal:

   An agent is bound to pay to his principal all sums received on his account [Sec. 218]. He may deduct therefrom all moneys due to himself in respect of advances made or expenses properly incurred by him in conducting such business and also such remuneration as may be payable to him for acting as agent [sec.217].

8. To protect and preserve the interests of the principal in case of his death or insolvency:

   When an agency is terminated by the principal dying or becoming of unsound mind, the agent is bound to take, on behalf of the representatives of his late principal, all reasonable steps for the protection and preservation of the interests entrusted to him [Sec. 209].

9. Not to use information obtained in the course of the agency against the principal:

   It is the duty of the agent to pass on any information which he receives in the course of the agency to his principal. Where he uses any such information against the interest of principal and the principal suffers a loss, he is bound to compensate the principal. The principal may also restrain the agent from using such information by an injunction.

10. Not to make secret profit from agency:

    An agent occupies fiduciary position. He must not, except with the knowledge and assent of the principal, make any profit beyond the agreed commission or remuneration.

11. Not to set up an adverse title:

    An agent must not set up his own title or the title of a third person (unless he proves a better title in that person) to the goods which he receives from the principal as an agent. If he does so, he will be liable for conversion (any act in relation to goods of another person which constitutes an unjustifiable denial of his title to them).

12. Not to put himself in a position where interest and duty conflict:

    An agent is under a duty, in all cases, to act in the interest of the principal. He must not put himself in a position where his duty to the principal and his personal interest conflict unless he has made full disclosure of his interest to his principal, specifying its exact nature and obtained his assent.

13. Not to delegate authority:

    An agent must not, as a general rule, depute another person to do what he has himself undertaken to do. This is subject to certain exceptions [Sec.190]

Check your progress – 16:

Discuss the duties of agents.

LESSON - 17

TERMINATION OF AGENCY

CONTENTS

1.17. 1 Modes of termination of agency
1.17. 2 Irrevocable agency
Check your progress: 17
Lesson End Activities
Let Us Sum Up

Termination of agency implies the end of the relationship of principal and agent.

1.17.1 MODES OF TERMINATION OF AGENCY

The various modes in which the agency may be terminated are as follows:

I. Termination of agency by act of the parties

1. By Mutual agreement: An agency is terminated if the principal and agent mutually agree to do so.
2. By revocation of authority by the principal: An agency is terminated if the principal revokes the authority of his agent. It may be noted that the principal may revoke the authority of his agent at any time before the authority has been exercised so as to bind the principal.
3. By renunciation of agency by the agent: The agency is terminated if the agent himself renounces the business of agency.

II. Termination of agency by operation of law

1. On completion of the business of the agency [Section 201]
   An agency is automatically terminated when the business of the agency is completed.
2. On death/ or on becoming of unsound mind of principal/agent [Section 201]
   An agency is automatically terminated when the principal or agent dies or becomes of unsound mind.

3. On insolvency of the principal:
   An agency is automatically terminated when the principal becomes insolvent because an insolvent person is incompetent to enter into a contract.

4. On expiry of fixed period:
   An agency is automatically terminated when the fixed term of agency expires even though the business of the agency has not yet been completed.

5. On destruction of the subject-matter:
   An agency is automatically terminated when the subject matter of the contract ceases to exist.

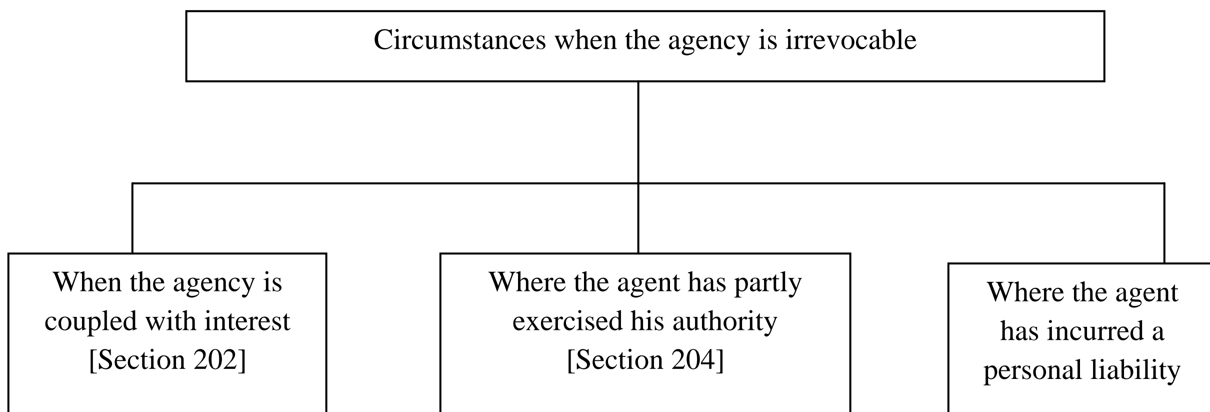
6. On winding up of company:
   An agency is automatically terminated when the principal or agent is a company and the company is wound up.

7. On principal becoming an alien enemy:
   An agency is automatically terminated when the principal and agent are citizen of two different countries and a war breaks out between these two countries.

1.17.2 IRREVOCABLE AGENCY

The term 'Irrevocable agency' means an agency which cannot be revoked or terminated by the principal.

The circumstances when the agency is irrevocable are:



a. Where the agency is coupled with interest:
   An agency is said to be coupled with interest when the object of creating the agency is to secure some benefit to the agent in addition to his remuneration as agent

b. Where the agent has partly exercised his authority:
The principal cannot revoke the authority given to his agent after the authority has been partly exercised, so far as regards such acts and obligations as arise from acts already done in the agency. Thus, the principal cannot revoke the agent's authority for the acts already done.

c. Where the agent has incurred a personal liability:
The principal cannot revoke the agent's authority for the authorised acts in respect of which the agent has already incurred a personal liability.

Check your progress – 17:

How are agencies terminated?

Lesson end activities:

1. X the principal, instructed Y his agent to insure the goods. Y failed to do so and the goods are destroyed by fire. Is Y liable to X?
2. Analyse various types of contracts and give your own examples for each of them.
3. Solve the following:

a. X invites Y to dinner. Y accepts the invitation but fails to turn up. Can X sue Y for damages?

b. X agrees to pay Rs.1,00,000 to Y if Y does not marry throughout his life. Y promises not to marry at all but later on X refuses to pay rs.1,00,000. Advise Y.

4. X the principal, instructed Y his agent to insure the goods. Y failed to do so and the goods are destroyed by fire. Is Y liable to X?

Let us sum up:

➢ CONTRACT
According to Section 2(h) of the Indian Contract Act, 1872, "An agreement enforceable by law is a contract." In other words, an agreement which can be enforced in a court of law is known as a contract. A contract must have the following two elements.
An agreement, and
Its enforceability by law

- ESSENTIAL ELEMENTS OF A VALID CONTRACT

  Offer and acceptance

  Minimum two persons

  Intention to create legal relationship

  Lawful consideration

  Capacity of parties – Competency

  Free and genuine consent

  Lawful consideration

  Agreement not declared void

  Certainty and possibility of performance

  Legal formalities

- An offer is the starting point in the making of an agreement. An offer is also called ‘proposal’. According to Section 2(a) of The Indian Contract Act, 1872, “A person is said to have made the proposal when he signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that offer to such act or abstinence.”

- Acceptance means giving consent to the offer. It is an expression by the offeree of his willingness to be bound by the terms of the offer. According to Section 2(b) of the Indian Contract Act, 1872, “A proposal is said to be accepted when the person to whom the proposal is made signifies his assent thereto. A proposal when accepted becomes a promise.”

- The term ‘revocation’ means ‘taking back’ or ‘withdrawal’.

- Minors, persons of unsound mind and persons prohibited by law cannot enter into contracts.

- The term ‘consideration’ means something in return.

- The consent means an act of assenting to an offer. “Two or more persons are said to consent when they agree upon the same thing in the same sense.”

- The object and the consideration of an agreement must be lawful, otherwise, the agreement is void.

- Restitution means ‘return or restoration of benefit.’

- A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract. In case of breach, the aggrieved party (i.e. the party not at fault) is relieved from performing his obligation and gets a right to proceed against the party at fault.
- 'Indemnity' means to make good the loss or to compensate the party who suffered some loss.
- A contract of guarantee is a contract to perform a promise or discharge the liability of a third person in case of his default.
- An agent is a person employed to do any act for another person or to represent another person in dealings with third persons. Thus, an agent establishes a contract between such another person and third person.
- An agent's authority means the capacity of the agent to bind his principal.
- Termination of agency implies the end of the relationship of principal and agent.
- The term 'Irrevocable agency' means an agency which cannot be revoked or terminated by the principal

UNIT – II

LESSON-18

LAW OF SALE OF GOODS

CONTENTS

2.18.1 Essential elements of a contract of sale
2.18.2 Sale and Agreement to sell
2.18.3 Sale and Hire purchase
2.18.4 Sale and Bailment
Check your progress: 18

AIMS AND OBJECTIVES

This unit aims at providing knowledge to the students about contract of sale, agreement to sell and hire purchase. The students will be able to get a clear idea about

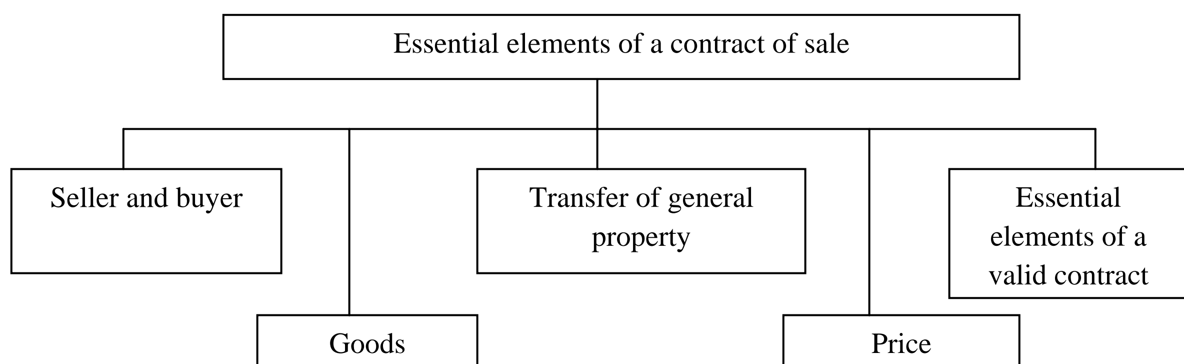
i. Types of goods
ii. Rights and duties of buyers
iii. Rights of unpaid seller and
iv. The doctrine of caveat emptor
after reading this unit.

INTRODUCTION

The Sale of Goods Act, 1930, extends to the whole of India except the State of Jammu and Kashmir.
The Sale of Goods Act, 1930
Contract of Sale:
A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price [Sec.4]. A contract of sale may be absolute or conditional.

2.18.1 ESSENTIAL ELEMENTS OF A CONTRACT OF SALE

The essential elements of a contract of sale are as follows:



Seller and buyer:

There must be a seller as well as a buyer. 'Buyer' means a person who buys or agrees to buy goods [Section 2 (1)]. 'Seller' means a person who sells or agrees to sell goods [Section 2(13)]. A person cannot be a seller as well as a buyer as a person cannot buy his own goods.

Goods:

There must be some goods. 'Goods' means every kind of movable property other than actionable claims and money and includes stock and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale [Sale 2(7)]. Contracts relating to actionable claims, immovable property and services are not covered by this Act.

i. The 'actionable claims' mean a claim which can be enforced through the courts of law. Eg., a due from one person to another is an actionable claim.
ii. The 'money' here means the legal tender (i.e., currency of the country) and not old coins.

Transfer of Property:

Property means the general property in goods, and not merely a special property [Section 2(11)]. General property in goods means ownership of the goods. Special property in goods means possession of goods. Thus, there must be either a transfer of ownership of goods or an agreement to transfer the ownership of goods. The ownership may transfer either immediately on completion of sale or sometime in future in agreement to sell.

Price:

There must be a price. Price here means the money consideration for a sale of goods. When the consideration is only goods, it amounts to a 'barter' and not sale. When there is no consideration, it amounts to gift and not sale. However, the consideration may be partly in money and partly in goods because the law does not prohibit as such.

Essential elements of a valid contract:

In addition to the aforesaid specific essential elements, all the essential elements of a valid contract as specified under Section 10 of Indian Contract Act, 1872 must also be present since a contract of sale is a special type of a contract.

2.18.2 SALE AND AGREEMENT TO SELL

The term 'Contract of sale' includes both a 'sale' and 'agreement to sell'.

Distinction between Sale and Agreement to Sell

	Basis of distinction	Sale	Agreement to sell
1	Transfer of ownership	Transfer of ownership of goods takes place immediately	Transfer of ownership of goods is to take place at a future time or subject to fulfilment of some condition
2	Executed contract or Executory contract	It is an executed contract because nothing remains to be done	It is an executor contract because something remains to be done
3	Conveyance of property	Buyer gets a right to enjoy the goods against the whole world including seller. Therefore, a sale creates jus in rem (Right against property)	Buyer does not get such right to enjoy the goods. It only creates jus in personam (Right against the person)
4	Transfer of risk	Transfer of risk of loss of goods takes place immediately because ownership is transferred. As a result, in case of destruction of goods, the loss shall be borne by the buyer even though the goods are in the possession of the seller	Transfer of risk of loss of goods does not take place because ownership is not transferred. As a result, in case of destruction of goods, the loss shall be borne by the seller even though the goods are in the possession of the buyer.
5	Rights of seller against the buyer's breach	Seller can sue the buyer for the price even though the goods are in his possession	Seller can sue the buyer for damages even though the goods are in the possession of the buyer.

6	Rights of buyer against the seller's breach	Buyer can sue the seller for damages and can sue the third party who bought those goods, for goods	Buyer can sue the seller for damages only.
7	Effect of insolvency of seller having possession of goods	Buyer can claim the goods from the official receiver or assignee because the ownership of goods has transferred to the buyer	Buyer cannot claim the goods even when he has paid the price because the ownership has not transferred to the buyer. The buyer who has paid the price can only claim rateable dividend
8	Effect of insolvency of the buyer before paying the price	Seller must deliver the goods to the official receiver or assignee because the ownership of goods has transferred to the buyer. He can only claim rateable dividend for the unpaid price.	Seller can refuse to deliver the goods unless he is paid full price of the goods because the ownership has not transferred to the buyer.

2.18.3 SALE AND HIRE PURCHASE AGREEMENT

Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes the agreement under which:

i. Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments;
ii. The property in the goods is to pass to such a person on the payment of the last instalment; and
iii. Such a person has a right to terminate the agreement at any time before the property so passes.

Distinction between a Sale and Hire-purchase agreement:

	Basis of distinction	Sale	Hire-purchase agreement
1	Regulating law	All contracts of sale are governed by Sale of Goods Act, 1930	The Hire-purchase agreements are governed by Hire Purchase Act, 1972
2	Nature of contract	It is a contract of sale	It is an agreement of hiring and hence an agreement to sell
3	Possession of goods	Possession of goods need not necessarily be transferred immediately	Possession of goods is necessarily transferred immediately
4	Transfer of ownership of goods	Ownership of goods is transferred immediately	Ownership of goods is transferred on the payment of the last instalment when the option to purchase is exercised
5	Right to terminate	The buyer has no right to terminate the contract of sale	The hirer has right to terminate the agreement at any time before the ownership is transferred
6	Right to repossess the goods	The seller has no right to repossess the goods. He can sue for price	The hire-vendor has a right to repossess the goods if the hirer defaults
7	Transfer of good title to third party	The buyer can transfer a good title to third party because ownership of goods bas been transferred	The hirer cannot transfer a good title to third party because ownership of goods has not been transferred
8	Compulsion as to be in writing	A contract of sale need not necessarily be in writing. The benefits of implied conditions and warranties are available	The hire-purchase agreement must be in writing.

9	Benefits of implied conditions and warranties under the Sale of Goods Act	The benefits of implied conditions and warranties are available	The benefits of implied conditions and warranties are not available.
10	Sales Tax	In case of sale of taxable goods, sales tax is levied	In case of hire of even taxable goods, sales tax is not levied.
11	Treatment of payment made by instalment	The payment made by the buyer is treated as payment towards the price of goods	The payment made by the hire purchases is treated as hire charges for the use of goods till the option to purchase the goods is exercised.

If in an agreement, the person taking the goods has an option to terminate the agreement at any time before the transfer of ownership of goods, it will be an agreement of hire purchase. If, in an agreement, the person taking the goods has no option to terminate the agreement, it will be a contract of sale even if the price is payable in instalments.

2.18.4 SALE AND BAILMENT

In a sale, the property in goods is transferred from the seller to the buyer. In a bailment, there is only transfer of possession from the bailor to the bailee. This may be for any one of the objects, namely, safe custody, use, carriage from one place to another etc. In a sale, the nuyer can deal with the goods in any way he likes. The bailee can deal with the goods according to the directions of the bailor.

Check your progress – 18:

Differentiate sale from agreement to sell.

LESSON-19

SUBJECT- MATTER OF CONTRCT OF SALE

CONTENTS

2.19.1 Classification of goods
2.19.2 Effect of destruction of goods
2.19.3 Document of title to goods
2.19.4 The Price
2.19.5 Stipulations as to time
Check your progress: 19

Goods form the subject-matter of a contract of sale. According to Sec 2 (7), '*goods*' means *every kind of movable property* other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Trademarks, copyrights, patent rights, goodwill, electricity, water and gas are all goods.

Actionable claims and money are not goods. An actionable claim means a claim to any debt or any beneficial interest in movable property not in possession (Sec. 3 of the Transfer of Property Act, 1882). It is something which can only be enforced by action in a Court of Law. A debt due from one person to another is an actionable claim and cannot be bought or sold as goods. It can only be assigned. Money here means current money and not old rare coins.

The definition of the term 'goods' also suggests that it includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed from the land before sale. Growing crops and grass are included in the definition of the term goods because they are to be severed from land. Trees which are agreed to be severed before sale or under the contract of sale are goods.

2.19.1 CLASSIFICATION OF GOODS

The goods which form the subject of a contract of sale may be either existing goods or future goods or contingent goods.

I. Existing Goods:

These are the goods which are owned or possessed by the seller at the time of sale. Only existing goods can be the subject of a sale. The existing goods may be-

a. Specific goods: These are goods which are identified and agreed upon at the time a contract of sale is made. For example, a specified watch, dog or horse. Goods are, however, not specific merely because the source of supply is identified.

b. Ascertained goods: Though commonly used as similar in meaning to specific goods, these are the goods which become ascertained subsequent to the formation of a contract of sale.

c. Unascertained or Generic goods: These are the goods which are not identified and agreed upon at the time of the contract of sale. They are defined only by description and may form part of a lot.

   Example: X who wants to buy a car set goes to a showroom where four models of Maruti cars are displayed. He sees the performance of a particular car, which he agrees to buy. The car so agreed to be bought is a *specific* car. If he marks a particular car, the car so marked becomes *ascertained*. Till this is done, all cars are unascertained.

II. Future Goods:
These are the goods which a seller does not possess at the time of the contract nut which will be manufactured or produced or acquired by him after the making of the contract of sale. A contract of present sale of future goods, though expressed as an actual sale, purports to operate as an agreement to sell the goods and not a sale. This is because the ownership of a thing cannot be transferred before that thing comes into existence.

III. Contingent Goods:
Though a type of future goods, these are the goods the acquisition of which by the seller depends upon a contingency which may or may not happen.
Example: A agrees to sell specific goods in a particular ship to B to be delivered on the arrival of the ship. If the ship arrives but with no such goods on board, the seller is not liable, for the contract is to deliver the goods only if they arrive.

2.19.2 EFFECT OF DESTRUCTION OF GOODS

1. Goods perishing before making of contract (Sec.7):
   A contract for the sale of specific goods is void if at the time when the contract was made, the goods have, without the knowledge of the seller, perished. The same would be the case where the goods become so damaged as no longer to answer to their description in the contract. This rule is based on the ground of mutual mistake or impossibility of performance.

Example: A cargo of dates was sold. The dates were contaminated with sea water so as to be unsaleable as dates, though they could be used for making spirits. Held, the contract was void as the dates no longer answered their description in the contract.

2. Goods perishing after the agreement to sell but before the sale is effected (Sec. 8): An agreement to sell specific goods becomes void if subsequently the goods, without any fault on the part of the seller or buyer, perish or become so damaged as no longer to answer to their description in the agreement before the risk passes to the buyer. 'Fault' means wrongful act or default. This rule is based on the ground of impossibility of performance.

Example: A agrees to sell to B 10 bales of Egyptian cotton out of 100 bales lying in his godown. The godown had been destroyed by fire at the time of the contract. Both A and B are unaware of this fact. The contract is not void as the sale here is not of specific goods, but of a certain quantity of unascertained goods. A must supply 10 bales of cotton or pay damages for the breach.

2.19.3 DOCUMENT OF TITLE TO GOODS

A document of title to goods is one which enables its possessor to deal with the goods described in it as if he were the owner. It is used in the ordinary course of business as proof of the possession or control of goods. It authorises, either by endorsement or by delivery, its possessor to transfer or receive goods represented by it. It symbolises the goods and confers a right on the purchaser to receive the goods or to further transfer such right to another person. This may be done by mere delivery or by proper endorsement and delivery.

Conditions to be fulfilled by a document of title to goods:

1. It must be used in the ordinary course of business.
2. The undertaking to deliver the goods to the possessor of the document must be unconditional.
3. The possessor of the document, by virtue of holding such document, must be entitled to receive the goods unconditionally.

Some examples of documents of title to goods are given below:

1. Bill of Lading: It is a document which acknowledges receipt of goods on board a ship and is signed by the captain of the ship or his duly authorised representative.

2. Dock Warrant: It is a document issued by a dock owner, giving details of the goods and certifying that the goods are held to the order of the person named in it or endorsee. It authorises the person holding it to receive possession of the goods..

3. Warehouse-keeper's or Wharfinger's certificate: It is a document issued by a warehouse-keeper or a wharfinger stating that the goods specified in the document are in his warehouse or in his wharf.
4. Railway Receipt: It is a document issued by a railway company acknowledging receipt of goods. It is to be resented by the holder or consignee at the destination to take delivery of the goods.
5. Delivery Order: It is a document containing an order by the owner of the goods to the holder of the goods on his behalf, asking him to deliver the goods to the person named in the document.

2.19.4 THE PRICE (SECS. 9 AND 10)

The "price" in a contract of sale means the money consideration for sale of goods [Sec. 2 (10)]. It forms an essential part of the contract. It must be expressed in money. It is the consideration for the transfer or agreement to transfer the property in goods from the seller to the buyer. It is not essential that the price should be fixed at the time of sale. It must, however, be payable, though it may not have been fixed.

2.19.5 STIPULATIONS AS TO TIME (SEC. 11)

Stipulations as to time in a contract of sale may be-

Stipulations relating to time of payment: These are not of the essence of a contract of sale, unless a different intention appears from the contract.

Stipulations not relating to time of payment: Eg., delivery of goods, etc. As regards these stipulations, time may be of the essence of the contract but this essentially depends on the terms of the contract.

Check your progress – 19:

What are the consequences/effects of destruction of goods in a contract of sale of goods?

LESSON-20

CONDITIONS AND WARRANTIES

CONTENTS

2.20.1 Condition
2.20.2 Warranty
2.20.3 When condition can be treated as warranty
2.20.4 Express and Implied Conditions and Warranties
Check your progress: 20

The stipulation in a contract of sale with reference to goods which are the subject thereof may be a condition or a warranty [sec. 12 (1)].

2.20.1 CONDITION [SEC. 12 (2)]

A condition is a stipulation which is essential to the main purpose of the contract. It goes to the root of the contract. Its non-fulfilment upsets the very basis of the contract. It is defined by Fletcher Moulton L.J. in Wallis vs. Pratt, (1910) 2 K.B. 1012 as an "obligation which goes so directly to the substance of the contract, or in other words, is so essential to its very nature, that its non-performance may fairly be considered by the other party as a substantial failure to perform the contract at all." If there is a breach of a condition, the aggrieved party can treat the contract as repudiated.

2.20.2 WARRANTY [SEC. 12 (3)]

A warranty is a stipulation which is collateral to the main purpose of the contract. It is not of such vital importance as a condition is. It is defined in Wallis vs. Pratt as an "obligation which, though it must be performed, is not so vital that a failure to perform it goes to the substance of the contract." If there is a breach of a warranty, the aggrieved party can only claim damages and it has no right to treat the contract as repudiated.

Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract as a whole. The Court is not to be guided by the terminology used by the parties to the contracts. A stipulation may be a condition though called a warranty in the contract [Sec. 12 (4)].

Distinction between a condition and warranty:

1. Difference as to value:
   A condition is a stipulation which is essential to the main purpose of the contract.
   A warranty is a stipulation which is collateral to the main purpose of the contract.

2. Difference as to breach:
   If there is a breach of a condition, the aggrieved party can repudiate the contract of sale.
   In case of a breach of a warranty, the aggrieved party can claim damages only.

3. Difference as to treatment:
   A breach of condition may be treated as a breach of a warranty. This would happen where the aggrieved party is contented with damages only.
   A breach of a warranty, however, cannot be treated as a breach of a condition.

2.20.3 WHEN CONDITION CAN BE TREATED AS WARRANTY (SEC.13)

1. Voluntary waiver of condition: Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may

(a) Waive the condition, or

(b) Elect to treat the breach of the condition as a breach of warranty [Sec. 13 (1)]
   If the buyer once decides to waive the condition, he cannot afterwards insist on its fulfilment.

2. Acceptance of goods by buyer: Where a contract of sale is not severable and the buyer has accepted the goods or part thereof, the breach of any condition to be fulfilled by the seller can only be treated as a breach of warranty, unless there is a term of the contract, express or implied, to the contrary.

2.20.4 EXPRESS AND IMPLIED CONDITIONS AND WARRANTIES

In a contract of sale of goods, conditions and warranties may be express or implied. Express conditions and warranties are those which are expressly provided in the contract. Implied conditions and warranties are those which the law implies into the contract unless the parties stipulate to the contrary.

Implied Condition:

1. Condition as to title:
   In a contract of sale, there is an implied condition on the part of the seller that

(a) In the case of a sale, he has a right to sell the goods, and

(b) In the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass.

2. Sale by description:
   Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description. If the sale is by sample as well as by description, the goods shall correspond both with the sample and the description.

3. Condition as to quality or fitness:
   The condition as to quality or fitness is implied where

(a) The goods sold are such as the seller deals in the ordinary course of his business

(b) The buyer relies on the seller's skill or judgment as to the fitness of the goods for any particular purpose, and

(c) The buyer expressly or impliedly makes known to the seller that he wants the goods for that particular purpose.

4. Condition as to merchantability:
   Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality.

5. Condition implied by custom:
   An implied condition as to quality or fitness for a particular purpose may be annexed by the usage of trade.

6. Sale by sample:
   In the case of a contract for sale by sample, there is an implied condition

(a) That the bulk shall correspond with the sample in quality

(b) That the buyer shall have a reasonable opportunity of comparing the bulk with the sample

(c) That the goods shall be free from any defect, rendering them unmerchantable, which would not be apparent on a reasonable examination of the sample.

7. Condition as to wholesomeness:
   In case of eatables and provisions, there is an implied condition that the goods shall be wholesome and fit for human consumption.

Implied warranties:

In a contract of sale, unless there is a contrary intention, there is an implied warranty that

(1) The buyer shall have and enjoy quiet possession of the goods, and

(2) The goods are free from any charge or encumbrance in favour of any third party.

Check your progress – 20:

Elaborate on express and implied conditions.

LESSON-21
CAVEAT EMPTOR

CONTENTS

2.21.1 The doctrine of Caveat Emptor
2.21.2 Exceptions
Check your progress: 21

2.21.1 THE DOCTRINE OF CAVEAT EMPTOR

This means "let the buyer beware", i.e., in a contract of sale of goods the seller is under no duty to reveal unflattering truths about the goods sold. Therefore, when a person buys some goods, he must examine them thoroughly. If the goods turn out to be defective or do not suit his purpose or if he depends upon his own skill or judgment and makes a bad selection, he cannot blame anybody excepting himself.

Example: H sent to a market 32 pigs to be sold by auction. The pigs were sold to W "with all faults and errors of description". H knew that the pigs were suffering from swine-fever, but he never disclosed this to W. Held, there was no implied warranty by H and the sale was good and H was not liable in damages. [Ward vs. Hobbs, (1878) 4 App. Cas 13].

The rule of caveat emptor is enunciated in the opening words of Sec.16 which runs thus: "Subject to the provisions of this Act and of any other law for the time being in force, there is no implied warranty or condition as to the quality or fitness for any particular purpose of goods supplied under a contract of sale...."

2.21.2 EXCEPTIONS

The doctrine of caveat emptor has certain important exceptions. They are:

1. Fitness for buyer's purpose:
   Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which he requires the goods and relies on the seller's skill or judgment and the goods are of a description which it is in the course of the seller's business to supply, the seller must supply the goods which shall be fit for the buyer's purpose.

2. Sale under a patent or trade name:
   In the case of a contract for the sale of a specified article under its patent or other trade name, there is no implied condition that the goods shall be reasonably fit for any particular purpose.

3. Merchantable quality:
   Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality. But if the buyer has examined the goods, there is no implied condition as regards defects which such examination ought to have revealed.

4. Usage of trade:
   An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade.

5. Consent by fraud:
   Where the consent of the buyer, in a contract of sale, is obtained by the seller by fraud or where the seller knowingly conceals a defect which could not be discovered on a reasonable examination (i.e., where there is a latent defect in the goods), the doctrine of caveat emptor does not apply.

Check your progress – 21:

Discuss the doctrine of caveat emptor and its important exceptions.

LESSON-22
TRANSFER OF PROPERTY

CONTENTS

2.22.1 Passing of property
2.22.2 Contracts involving sea-routes
Check your progress: 22

There are three stages in the performance of a contract of sale of goods by a seller, namely

1. The transfer of property in the goods
2. The transfer of possession of the goods (i.e., delivery) and
3. The passing of the risk.

Transfer of property in goods from the seller to the buyer is the main object of a contract of sale. ‘Property in goods’ means the ownership of goods whereas ‘possession of goods’ refers to the custody or control of goods. An article may belong to A although it may not be in his possession. B may be in possession of that article although he is not its owner.

It is important to know the precise moment of time at which the property in goods passes from the seller to the buyer for the following reasons:

1. Risk follows ownership:
   Unless otherwise agreed, risk follows ownership whether delivery has been made or not and whether price has been paid or not. Thus, the risk of loss as a rule lies on the owner. Sec.26 provides in this regard that, unless otherwise agreed, the goods remain at the seller’s until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer’s risk, whether delivery has been made or not. But if deliver has been delayed through the fault of either the buyer or the seller, the goods are at the risk of the party at fault. Thus ‘risk’ and ‘property’ go together.

2. Action against third parties:
   When the goods are in any way damaged or destroyed by the action of third parties, it is only the owner of the goods who can take action against them.

3. Insolvency of the seller or the buyer:
   In the event of insolvency of the seller or the buyer, the question whether the Official Receiver or Assignee can take over the goods or not depends on whether the property in the goods has passed from the seller to the buyer.

4. Suit for price:
   The seller can sue for the price, unless otherwise agreed, only if the goods have become the property of the buyer.

2.22.1 PASSING OF PROPERTY

The primary rules for ascertaining when the property in goods passes to the buyer are as follows:

1. Goods must be ascertained:
   Where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are ascertained.

2. Intention of the parties:
   Where there is a contract for the sale of specific or ascertained goods, the property in them passes to the buyer at the time when the parties intend it to pass. For the purpose of ascertaining the intention of the parties, regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case.
   Where the intention of the parties cannot be ascertained:
   Where the intention of the parties as to the time when the property in the goods is to pass to the buyer cannot be ascertained from the contract, the rules contained in Secs.20 to 24 apply. These rules are as follows:

I. Specific goods (Secs. 20 to 22)
   The rules relating to transfer of property in specific goods are as follows:

(a) Passing of property at the time of contract: Where there is an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when the contract is made. The fact that the time of payment of the price or the time of delivery of goods, or both, is postponed does not prevent the property in goods passing at once.

    ‘Deliverable state’ means such a state that the buyer would under the contact be bound to take delivery of the goods.

(b) Passing of property delayed beyond the date of the contract:

i. Goods not in a deliverable state: Where there is a contract for the sale of specific goods not in a deliverable state, i.e., the seller has to do something to the goods to put them into a deliverable state, the property does not pass until such thing is done and the buyer has notice of it.

ii. When the price of goods is to be ascertained by weighing, etc.: Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof.

II. Unascertained goods (Sec. 23):

Where there is a contract for the sale of unascertained goods, the property in the goods does not pass to the buyer until the goods are ascertained. Until goods are ascertained there is merely an agreement to sell. The Act further provides that where there is a contract for the sale of unascertained or future goods by description and goods of that description and in a deliverable state are unconditionally appropriated to the contract, the property in the goods thereupon passes to the buyer.

The 'ascertainment of goods' and their unconditional "appropriation to the contract" are the two pre-conditions for the transfer of property from the seller to buyer in case of unascertained goods.

'Ascertainment' is the process by which the goods answering the description are identified and set apart.

'Appropriation' involves selection of goods with the intention of using them in performance of the contract and with the mutual consent of the seller and the buyer. The appropriation must be unconditional. It is unconditional when the seller does not reserve to himself the right of disposal of the goods.

Delivery to carrier:

A seller is deemed to have unconditionally appropriated the goods to the contract where he delivers them to the buyer or to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal.

III. Goods sent on approval or 'on sale or return' (Sec.24):

When goods are delivered to the buyer on approval or 'on sale or return' or other similar terms, the property therein passes to the buyer:

i. When he signifies his approval or acceptance to the seller

ii. When he does any other act adopting the transaction

If the seller delivers the goods to the buyer 'on sale or return' on the terms that the goods were to remain his property until settled or paid for the property would not pass to the buyer until there terms are complied with.

iii. If he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, beyond the time fixed for the return of the goods, or if no time has been fixed, beyond a reasonable time.

2.22.2 CONTRACTS INVOLVING SEA ROUTES

In contracts of sale which involve sea routes, certain special clauses and conditions are to be found. The meaning of these clauses has been standardised to an extent in accordance with the international customs and practices of merchants. Some of these clauses which are quite often found in such contracts and their legal effects are as follows:

C.I.F CONTRACTS - (Named port of destination):

C.I.F stands for "cost, insurance and freight". If A of Delhi agrees to sell 100 bags of rice at Rs.2,500 per bag, C.I.F. Manchester, the sum of Rs.2,50,000 (100 x 2,500) includes

1. the price of the goods,
2. the cost of insurance, and
3. the freight up to Manchester

C.I.F. contract is performed by the delivery of documents (bill of lading, insurance policy, invoice, certificate of origin etc.) representing the goods to the buyer, through a bank. The documents are usually delivered by the bank against payment of the price, or against acceptance of a draft (bill of exchange). This protects both the seller and the buyer. The seller continues to be the owner of the goods until the buyer pays for the goods and gets the documents. If, in the meantime, the goods are lost at sea, the buyer or the seller, whoever is the owner at the time of the loss, can recover the amount from the insurer. If, on receiving the goods, the buyer finds that they are not according to the contract, he may reject them and recover the price paid by him.

Seller's duties:

1. To make out an invoice of the goods sold.
2. To ship at the port of shipment goods of the description contained in the contract
3. To procure a contract of affreightment, under which the goods will be delivered at the destination contemplated by the contract.
4. To arrange for insurance upon the terms current in the trade that will be available for the benefit of the buyer. If the seller does not effect insurance, the buyer is not bound to accept and pay for the goods even if the goods arrive safely at the destination.
5. To tender, within a reasonable time after shipment, the bill of lading, the policy of insurance and the invoice and other documents to the buyer, so that he may obtain delivery of the goods, if they arrive, or recover for their loss if they are lost on the voyage.

The bill of lading tendered must correctly state the date of shipment of the goods, otherwise the buyer can reject the goods.

Buyer's duties:

1. To accept the documents if they are complete and regular, and pay the price less the freight, on delivery of the documents. The buyer is bound to do so even if the goods have been destroyed, for he has a remedy against the insurer of the goods.
2. To pay the unloading, wharfage charges, etc., at the port of destination.
3. To pay all customs and import charges.

In the case of a C.I.F. contract, the buyer has the right to reject

a. The documents if they are not in order
b. The goods if they do not conform to the contract of sale

C.I.F. contract is a contract for the sale of insured goods, lost or not lost, to be implemented by transfer of proper documents.

Transfer of Property :

In a C.I.F contract, the property in the goods passes from the seller to the buyer when the goods are shipped unless, as usually happens, the seller reserves the right of disposal. If the seller parts with control over the disposal of the goods, the property in the goods passes to the buyer. The seller indorses the bill of lading to the buyer. But if the seller indorses the bill of lading in blank and sends it to his agent to be delivered to the buyer only against payment of the price, or acceptance of the draft, he retains the disposal of the goods under his control. And till the price is paid or the draft is accepted, the property in the goods does not pass to the buyer.

F.O.B. CONTRACTS – (Named port of shipment):

F.O.B. stands for "free on board". If A of Delhi agrees to sell 100 tonnes of sugar, F.O.B. Mumbai, to B of Manchester, this would mean that A must put the goods on board a ship at Mumbai at his own expense under a contract of carriage by sea, to be made by or on behalf of the buyer, for the purpose of transmission to the buyer,

Seller's duties:

1. To deliver the goods on board the ship named by the buyer. When once the goods are put on board the ship, they are at the risk of the buyer. The duty of the seller ends when he delivers the goods at his own expense to the ship at the port of shipment. Such delivery transfers the possession, property and risk to the buyer.

2. To give notice of the shipment to the buyer so as to enable him to protect himself by insurance against loss during the sea transit; if the seller fails to do this, the goods will be at his risk.

Buyer's duties:

1. To arrange for the contract of affreightment.
2. To name the ship to which the goods are to be delivered or to authorise the seller to select the ship.
3. To pay all charges and bear all risks subsequent to delivery of the goods on board the ship.

The property in goods does not pass to the buyer until the goods are delivered on board the ship. If the seller is prevented from putting the goods on board the ship by the failure of the buyer to name a ship, the seller can sue for damages for non-acceptance and not for the price.

F.A.S. CONTRACTS

F.A.S. stands for 'free alongside ship'. The property in goods sold under an F.A.S. contract passes from the seller to the buyer when the goods are delivered alongside the ship named by the buyer under a contract of carriage.

Seller's duties:

1. To deliver the goods alongside the ship.
2. To notify the buyer immediately that the goods have been delivered alongside the ship.

Buyer's duties:

1. To arrange for the contract of affreightment.
2. To give the seller sufficient notice of the name of the ship and time for delivery alongside the ship.
3. To pay all charges and to bear all risks from the time the goods are delivered alongside the ship.

EX-SHIP CONTRACTS – (Named ship and named port of delivery):

These are contract under which the seller causes the delivery of the goods to be made to the buyer from a ship which has arrived at the port of destination at his (seller's) expense. In such contracts, the property in the goods does not pass to the buyer until the goods are actually delivered to him.

Seller’s duties:

1. To deliver the goods to the buyer from a ship which has arrived at the port of destination at a place from which it is usual for goods of that kind to be delivered.
2. To pay the freight or otherwise release the ship owner’s lien.
3. To furnish the buyer with a delivery order, or some other effectual direction to the ship owner to deliver.

In the case of an ex-ship contract, the property and risk in the goods do not pass to the buyer until they are delivered at the port of destination. The goods are at the seller’s risk during the voyage and there is no obligation on him to effect an insurance on behalf of the buyer.

Check your progress – 22:

1. Discuss the types of goods.

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2. What are the three stages in performance of contract?

LESSON-23

SALE BY NON-OWNERS

CONTENTS

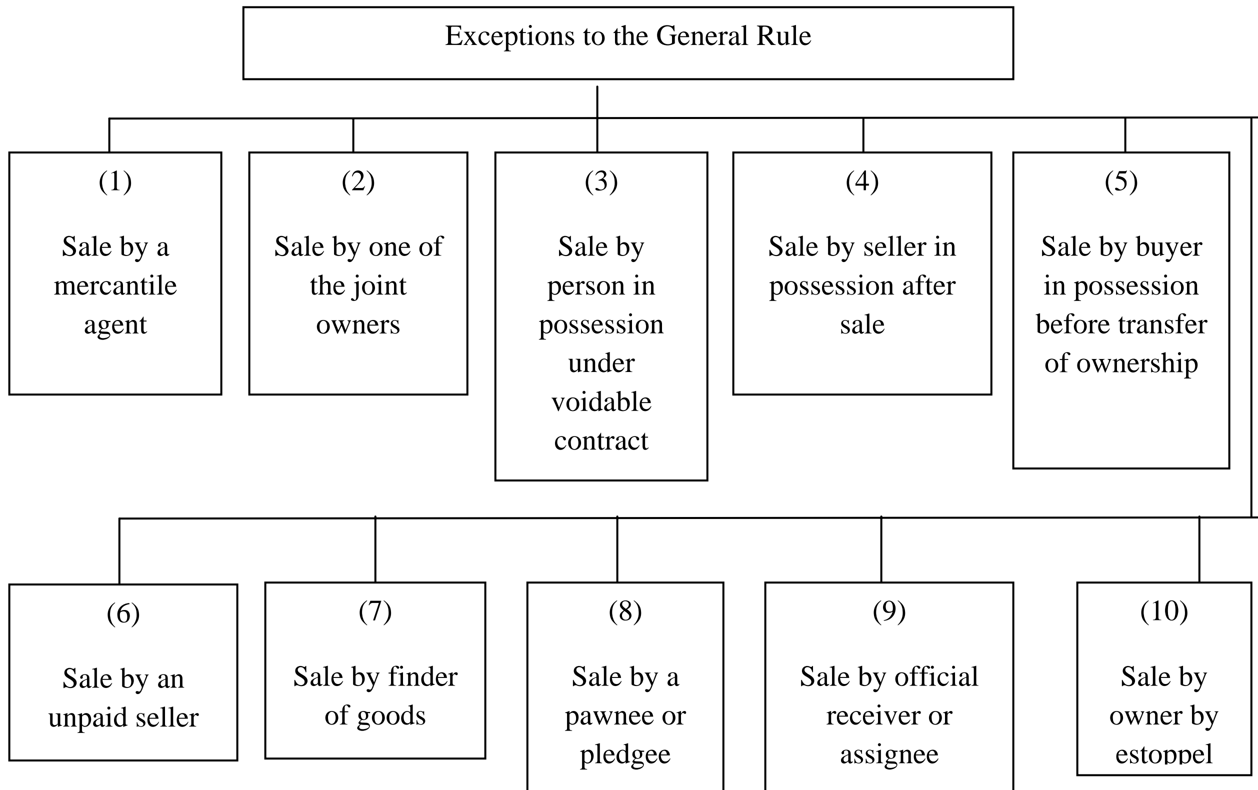
2.23.1 The general rue
2.23.2 Exceptions to the general rule
Check your progress: 23

2.23.2 THE GENERAL RULE

The general rule of law is that ‘no one can give that which one has not got’. It is only the owner of the goods, or a person authorised by him, who can sell the goods. If the seller has no title to the goods, the buyer does not acquire any although he may have acted honestly and may have paid value for the goods. This protects the owner of the goods. Sec. 27 also provides that where goods are sold by a person who is not the owner thereof and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had. This is, however, subject to certain exceptions.

2.23.2 EXCEPTIONS TO THE GENERAL RULE

The circumstances under which a seller can give a better title than what he himself has, are as follows:



The various exceptions to the general rule and the conditions for their application are summarised below:

Exceptions to the general rule	Conditions to be fulfilled before a buyer gets a good title to the goods
1. Sale by a mercantile agent [Sec. 27]	(i) The agent must be in possession of goods or a document title (e.g., Railway receipt, Bill of lading) to the goods with the consent of the owner. (ii) The agent must have sold the goods in the ordinary course of business as a mercantile agent. (iii) The buyer must have acted in good faith (iv) The buyer must have no knowledge that the seller had no authority to sell. ***Example:*** *P, the owner of a car instructed an agent A to sell his car at not less than Rs.1,00,000. But A sold the car to B for Rs.80,000 and misappropriated the money. B acted in good*

	faith and without notice of the above instruction to agent. Here, B got a good title to the car and the real owner P cannot recover the car from B. [Folkes vs. King].
2. Sale by one of the joint owners [Sec. 280]	(i) The joint owner must be in the sole possession of goods with the consent of other co-owners (ii) The buyer must have bought the goods in good faith (iii) The buyer must have no knowledge that the seller had no authority to sell. ***Example:*** *X, Y and Z were the co-owners of some goods. X was in possession of those goods with the consent of Y and Z. X sold those goods to B who bought them in good faith and without notice that X had no authority to sell. In this case, B got a good title to the goods and Y and Z cannot recover the goods from B.*
3. Sale by a person in possession under voidable contract	(i) The seller must be in possession of goods under a contract voidable under section 19 or 19A of Indian Contract Act, 1872 on ground of coercion, undue influence, misrepresentation or fraud. (ii) The goods must have been sold before the contract is rescinded (iii) The buyer must have bought the goods in good faith. (iv) The buyer must have no knowledge that the seller's title is defective. ***Example:*** *X, by fraud obtained the possession of a diamond ring from Y. X sold the ring to B before Y rescinded the contract. B bought the ring in good faith and without notice of X's defective title. B got a good title and Y cannot recover the ring from B. [Phillips vs. Brooks].*

4. Sale by seller in possession after sale [Sec. 30(1)]	(i) The seller must be in possession of goods or of a document of title to the goods, in the capacity of a seller and not in any other capacity such as bailee. (ii) The buyer must have bought the goods in good faith. (iii) The buyer must have no knowledge about the previous sale. ***Example:*** *X sold two TV sets to Y with the terms that one to be delivered immediately and another to be delivered after 2 days. Later on, Y delivered the first TV to X for some minor repair. X resold the first TV to P and the second to Q. Both P and Q bought in good faith and without notice of the previous sale. Here, Q got a good title to the TV but P did not get good title because X was in the possession of TV in the capacity of a bailee and not in the capacity of a seller.*
5. Sale by a buyer in possession before the transfer of ownership [Sec. 30(2)]	(i) The buyer must be in possession of the goods or a document of title to the goods, with the consent of the original seller and must have bought or agreed to buy the goods. (ii) The new buyer must have bought the goods in good faith. (iii) The new buyer must have no knowledge about any lien or other right of the original seller in respect of goods. ***Example:*** *X takes the delivery of a furniture from Y under an agreement which provides for* *(a) An immediate down payment of Rs.5,000,* *(b) The balance by way of 12 monthly instalments of Rs.1,000 each,* *(c) Transfer of ownership on the payment of last instalment,* *(d) Y's right to repossess the goods in case of non-payment of instalments due.*

	Before the 12th instalment was paid, X sold the furniture to Z. Can Y recover the furniture from Z? State your answer in each of the following cases. Case (i) : If the agreement does not provide for any other stipulation Case (ii) : If the agreement also provides that X can return the goods. ***Solutions:*** *Case (i) : Y cannot recover the furniture from Z because it was a contract of sale (as X was not having any option to return but was under compulsion to buy) and not hire-purchase agreement.* *Case (ii) : Y can recover the furniture from Z because it was a hire-purchase agreement (as X was having an option to return) and hence, X was not having any title to it.* Note: A buyer (being hirer in case of a hire purchase agreement) cannot transfer a valid title to the new buyer because an 'option to buy does not amount to an "agreement to buy'''.
6. Sale by an unpaid seller [Sec. 54(3)]	An unpaid seller must have exercised his right of lien or stoppage in transit.
7. Sale by a Finder of goods [Sec. 169 of the Indian Contract Act, 1872]	(i) The owner cannot be found with reasonable diligence, or (ii) The owner, if found refuses to pay the lawful charges of finder, or (iii) If the goods are in danger of perishing or of losing the greater part of its value, or (iv) If the lawful charges of the finder in respect of the thing found amounts to two third of its value
8. Sale by a pawnee or pledgee	(i) The pawnor or pledger must have made a default in the payment of the debt or the performance of the promise at the stipulated time. (ii) The pawnee or pledge must have given a reasonable notice to the pawnor or pledger.

9. Sale by Official Receiver or Assignee or Liquidator	The involved person must be the owner of goods.
10. Sale by owner by estoppel	The owner of the goods by his statement or conduct must have lead the buyer to believe that the seller has the authority to sell. ***Example:*** *X told Y, a buyer in the presence of Z that he (X) is the owner of the TV. But Z remained silent though the TV belonged to him. Y bought the TV from X. Here, Y will get a valid title to the TV even though X had no title to the TV because Z by his own conduct is prevented from denying X's authority to sell the TV.*

Check your progress – 23:

Who are considered as non-owners of goods?

LESSON-24
DELIVERY

CONTENTS

2.24.1 Delivery
2.24.2 Types of Delivery
2.24.3 Rules as to Delivery
Check your progress: 24

2.24.1 DELIVERY

Delivery means the voluntary transfer of possession from one person to another.

Delivery of goods may be made-

(a) By doing anything which the parties agree shall be treated as delivery, or

(b) By doing anything which has the effect of putting the goods into the buyer's or his authorised agent's possession

2.24.2 TYPES OF DELIVERY

The delivery of goods may be of the following three types:

(i) Actual Delivery:
Delivery is said to be actual where the goods are physically handed over to the buyer or his authorised agent.
Example: X sells to Y 100 bags of wheat lying in Z's warehouse. X orders Z to deliver the wheat to Y. Z delivers to Y. In this case there is an actual delivery of goods.

(ii) Symbolic Delivery:
Delivery is said to be symbolic where some symbol of the real possession or control over the goods is handed over to buyer.
Example: X sells to Y 100 bags of wheat lying in Z's warehouse and hands over the key of Z's warehouse to Y. In this case, there is symbolic delivery of goods.

(iii) Constructive Delivery:
Delivery is said to be constructive where a person who is in possession of the goods, acknowledges to hold the goods on behalf of the buyer.
Example: X sells to Y 100 bags of wheat lying in Z's warehouse. Y orders Z to deliver the wheat to Y. Z agrees to hold the 100 bags of wheat on behalf of Y and makes the necessary entry in his books. In this case, there is constructive delivery of goods.

2.24.3 RULES AS TO DELIVERY [SECTIONS 32 TO 39]

1. Payment and Delivery to be concurrent:
   Unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions. They must happen simultaneously.

2. Mode of delivery:
   Delivery must have the effect of putting the goods into the buyer's or his authorised agent's possession.

3. Effect of part delivery:
   A delivery of part of goods with an intention of giving the delivery of the whole amounts to the delivery of the whole for the purpose of transfer of ownership of goods, but a delivery of part of goods with an intention of separating it from the whole lot does not amount to the delivery of the whole of the goods.

4. Buyer to apply for delivery;
   Unless otherwise agreed, the seller of the goods is not bound to deliver them until the buyer applies for delivery.

5. Place of delivery:
   Where there is a contract as to the place of delivery, the goods must be delivered at the agreed place.

6. Time of delivery:
   Where there is a contract as to the time of delivery, the goods are to be delivered within the time agreed.

7. Delivery when the goods are in possession of a third party:
   Where the goods at the time of sale are in the possession of a third person, there is no delivery by seller unless and until such third person acknowledges to the buyer that he holds the goods on his behalf. However, this provision shall not affect the operation of the issue or transfer of any document of title to goods.

8. Demand of delivery to be treated as ineffectual:
   Demand or tender of delivery may be treated as ineffectual unless made at a reasonable hour.

9. Expenses of delivery:
   Unless otherwise agreed, the expenses of putting the goods into a deliverable state shall be borne by the seller.

10. Delivery of wrong quantity:
    Subject to any usage of trade, special agreement or course of dealing between the parties, the rules as to the delivery of wrong quantity are as under:

Case	Rights available to the buyer
I. Short delivery, i.e., where the seller delivers a quantity of goods less than contracted for	(a) The buyer may accept the goods so delivered, or (b) The buyer may reject the goods
II. Excess delivery, i.e., where the seller delivers a quantity of goods larger than contracted for	(a) The buyer may accept the goods so delivered, (b) The buyer may reject the whole, or (c) The buyer may accept the contracted quantity and reject the excess.
III. Mixed delivery, i.e., where the seller delivers the goods contracted for mixed with goods of different description Note: The mixing of goods with inferior quality does not amount to mixing of goods of different description.	(a) The buyer may reject the whole, or (b) The buyer may accept the goods which are in accordance with the contract and reject the rest

11. Delivery by Instalments:
    Unless otherwise agreed, the buyer of goods is not bound to accept delivery by instalments.

The question whether the aggrieved party can repudiate the whole contract or not depends upon the terms of the contract and the circumstances of each case where-

(i) The goods are to be delivered in instalments

(ii) The instalments are to be separately paid for

(iii) The seller makes no delivery or defective delivery in respect of one or more instalments, or the buyer neglects or refuses to take delivery of or pay for one or more instalments.

12. Delivery to Carrier or Wharfinger:
Where the seller is authorised or required to send the goods to the buyer, delivery of the goods to carrier (whether named by the buyer, or not) for the purpose of transmission to the buyer, or delivery of the goods to wharfinger custody, is prima facie deemed to be a delivery of the goods to the buyer. The seller is further required to perform the following two duties also:

(i) To make a reasonable contract with the carrier or wharfinger,

(ii) To give notice to the buyer to enable him to insure the goods.

Check your progress – 24:

State the rules regarding delivery of goods.

LESSON-25
RIGHTS AND DUTIES OF A BUYER

CONTENTS

2.25.1 Rights of the buyer
2.25.2 Duties of the Buyer
Check your progress: 25

2.25.1 RIGHTS OF THE BUYER

1. Right to have delivery as per contract:
   The first right of the buyer is to have delivery of the goods as per contract.

2. Right to reject the goods if the seller sends to the buyer a larger or smaller quantity of goods than he ordered:
   If the seller sends to the buyer a larger or smaller quantity of goods than he ordered, the buyer may

a. Reject the whole

b. Accept the whole, or

c. Accept the quantity he ordered and reject the rest.

3. Right to repudiate the contract;
   Unless otherwise agreed, the buyer of the goods has a right not to accept delivery thereof by instalments.

4. Right to notice of insurance:
   Unless otherwise agreed, where goods are sent by the seller to the buyer by a sea route, the buyer has a right to be informed by the seller so that he may get the goods insured.

5. Right to examine the goods which he previously has not examined before he accepts them:

The buyer has a right to examine the goods which he has not previously examined before he accepts them.

6. Right against the seller for breach of contract

(a) Suit for damages:
Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery.

(b) Suit for price:
If the buyer has paid the price and the goods are not delivered, he can recover the amount paid.

(c) Suit for specific performance:
The buyer may sue the seller for specific performance of the contract to sell. If the goods are specific or ascertained, the Court may, if it thinks fit, order for the specific performance of the contract
.

(d) Suit for breach of warranty:
Where there is a breach of warranty by the seller, or where the buyer elects or is compelled to treat any breach of condition on the part of the seller as a breach of warranty, the buyer is not by reason only of such breach of warranty entitled to reject the goods. But he may

1. Set up against the seller the breach of warranty in diminution or extinction of the price, or

2. Sue the seller for damages for breach of warranty.

(e) Repudiation of contract before due date:
When the seller repudiates the contract before the date of delivery, the buyer may either treat the contract as subsisting and wait till the date of delivery, or he may treat the contract as rescinded and sue for damages for the breach. This rule is known as the 'rule of anticipatory breach of contract'.

(f) Suit for interest:
Where there is a breach of contract on the part of the seller and as a result the price has to be refunded to the buyer, the buyer has a right to claim interest on the amount of the price refunded to him from the date on which the payment was made. The Court may award the interest at such rate as it thinks fit.

3.17.2 DUTIES OF THE BUYER

1. Duty to accept the goods and pay for them in exchange for possession:
It is the duty of the buyer to accept the goods and pay for them, in accordance with the terms of the contract of sale. Further, the buyer must be ready and willing to pay the price in exchange for possession of the goods.

2. Duty to apply for delivery:
   Apart from any express contract, it is the duty of the buyer to apply for delivery.

3. Duty to demand delivery at a reasonable hour:
   It is the duty of the buyer to demand delivery at a reasonable hour.

4. Duty to accept in instalment delivery and pay for it, if it is agreed so in advance

5. Duty to take risk of deterioration in the goods in the course of transit:
   Where the seller of goods agrees to deliver them at his own risk at a place other than where they are sold, the buyer shall take any risk of deterioration in the goods necessarily incident to the course of transit.

6. Duty to intimate the seller when he rejects the goods:
   Unless otherwise agreed, it is the duty of the buyer to inform the seller in case he refuses to accept the goods.

7. Duty to take delivery of goods within a reasonable time:
   It is the duty of the buyer to take delivery of the goods within a reasonable time after the tender of delivery. He becomes liable to the seller for any loss occasioned by his neglect or refusal to take delivery.

8. Duty to pay price according to the terms of the contract:
   Where property in goods has passed to the buyer, it is his duty to pay the price according to the terms of the contract.

9. Duty to pay damages for non-acceptance by negligence or wrongful refusal to accept and pay for the goods:
   Where the buyer wrongfully neglects or refuses to accept and pay for the goods, he will have to compensate the seller, in a suit by him, for damages for non-acceptance.

Check your progress – 25

Discuss the rights and duties of a buyer of goods.

LESSON-26
RIGHTS OF AN UNPAID SELLER

CONTENTS

2.26.1 Rights against goods
2.26.2 Rights against the buyer personally
Check your progress: 26
Lesson End Activities
Let Us Sum Up

(Unpaid Vendor's Rights)

A seller of goods is deemed to be an unpaid seller when-

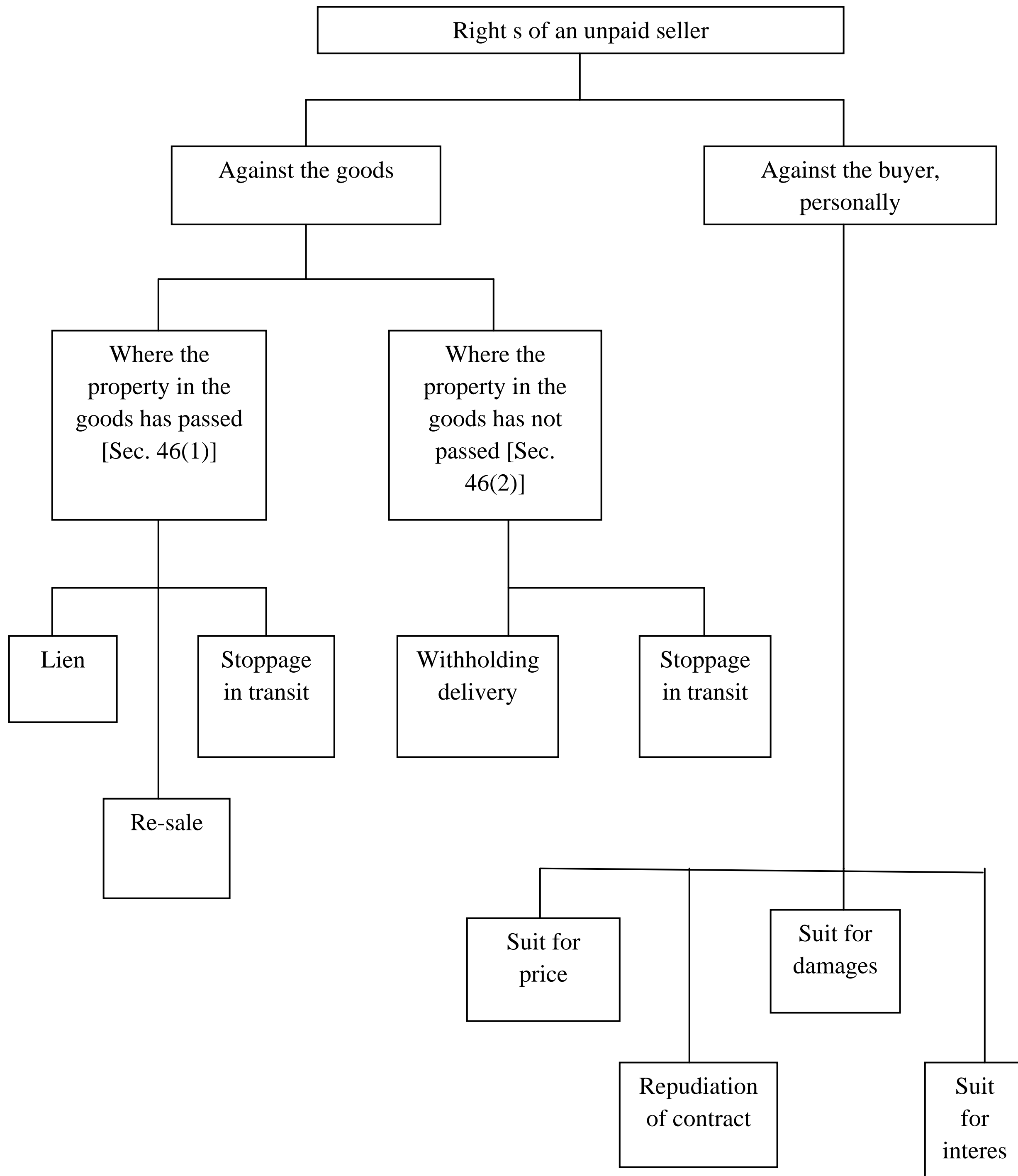
1. The whole of the price has not been paid or tendered (offered to be paid)
2. A bill of exchange or other negotiable instrument has been received as a conditional payment, and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

The following conditions must be fulfilled before a seller of goods can be deemed to be an unpaid seller:

1. He must be unpaid and the price must be due
2. He must have an immediate right of action for the price
3. A bill of exchange or other negotiable instrument was received but the same has been dishonoured.

When payment is made by a negotiable instrument it is usually a conditional payment, the condition being that the instrument shall be duly honoured. If the instrument is not honoured, the seller is deemed to be an 'unpaid seller'. A seller who has obtained a money decree for the price of the goods is still an unpaid seller if the decree has not been satisfied.

'Seller' here means not only the actual seller, but also any person who is in the position of a seller, e.g., an agent of the seller to whom a bill of lading has been endorsed, or a consignee or agent who has himself paid for the goods or is directly responsible for the price [Sec, 45(2)].



2.26.1 RIGHTS AGAINST GOODS

Rights of an unpaid seller against the goods:
Where the property in the goods has passed to the buyer, an unpaid seller has the following rights against the goods:

i. Right of lien:

A lien is a right to retain possession of goods until payment of the price. It is available to the unpaid seller of the goods who is in possession of them where-

a. The goods have been sold without any stipulation as to credit

b. The goods have been sold on credit, but the term of credit has expired

c. The buyer becomes insolvent

ii. Right of stoppage in transit:
The right of stoppage in transit is a right of stopping the goods in transit after the unpaid seller has parted with the possession of the goods. He has the further right of resuming possession of the goods as long as they are in the course of transit, and retaining possession until payment or tender of the price. It is available to the unpaid seller-

a. When the buyer becomes insolvent, and

b. When the goods are in transit

The buyer is said to be 'insolvent' when he has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due, whether he as committed an act of insolvency or not.

The right of stoppage in transit is an extension of the right of lien, but it arises only on the insolvency of the buyer and when the goods are in transit.

Transit is an intermediate stage. Goods are deemed to be in course of transit from the time they are delivered to a carrier, or other bailee for the purpose of transmission to the buyer, until the buyer or his agent takes delivery of them from such carrier or other bailee.

iii. Right of Re-sale:
The unpaid seller can re-sell the goods-

a. Where the goods are of a perishable nature, or

b. Where he gives notice to the buyer of his intention to re-sell the goods and the buyer does not within a reasonable time pay or tender the price.

If, on re-sale, there is a loss to the seller, (i.e., the difference between the contract price and the amount realised on re-sale of the goods), he can claim it from the buyer as damages for breach of contract. If there is a surplus on the re-sale, he is not bound to hand it over to the buyer because the buyer cannot be allowed to take advantage of his own wrong.

Where the property in the goods has not passed to the buyer, an unpaid seller has the following rights against the goods:

iv. Right of withholding delivery:
Where the property in goods has not passed to the buyer, an unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and co-extensive with his rights of lien and stoppage in transit where the property has passed to the buyer.

v. Right of stoppage in transit:
The right of stoppage in transit is a right of stopping the goods in transit after the unpaid seller has parted with the possession of the goods. He has the further right of resuming possession of the goods as long as they are in the course of transit, and retaining possession until payment or tender of the price. It is available to the unpaid seller-

a. When the buyer becomes insolvent, and
b. When the goods are in transit

The buyer is said to be 'insolvent' when he has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due, whether he as committed an act of insolvency or not.

The right of stoppage in transit is an extension of the right of lien, but it arises only on the insolvency of the buyer and when the goods are in transit.

Transit is an intermediate stage. Goods are deemed to be in course of transit from the time they are delivered to a carrier, or other bailee for the purpose of transmission to the buyer, until the buyer or his agent takes delivery of them from such carrier or other bailee.

2.26.2 RIGHTS AGAINST THE BUYER PERSONALLY

Rights of an unpaid seller against the buyer personally:
These are the rights which an unpaid seller may enforce against the buyer personally. These rights of the seller against the buyer are called rights in personam as against the rights in rem (i.e., the rights against the goods), and are in addition to his rights against the goods. The rights in personam are as follows:

i. Suit for price;

a. Where property has passed:
Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods, the seller may sue him for the price of the goods.

b. Where property has not passed:
Where under a contract of sale the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price. It makes no difference even if the property in the goods has not passed and the goods have not been appropriated to the contract.

ii. Suit for damages:
Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for non-acceptance.

iii. Repudiation of contract before the due date:
Where the buyer repudiates the contract before the date of delivery, the seller may either-

a. Treat the contract as subsisting and wait till the date of delivery, or

b. He may treat the contract as rescinded and sue for damages for the breach. This rule is known as 'the rule of anticipatory breach of contract'.

iv. Suit for interest:

Where there is a specific agreement between the seller and the buyer as to interest on the price of the goods from the date on which payment becomes due, the seller may recover interest from the buyer. If, however there is not specific agreement to this effect, the seller may charge interest on the price when it becomes due from such day as he may notify to the buyer.
In the absence of a contract to the contrary, the Court may award interest to the seller in a suit by him at such rate as it thinks fit on the amount of the price from the date of the tender of the goods or from the date on which the price was payable [Girija Prasad vs. Sardar Labh Singh, A.I.R. (1977) Pat. 241].

Check your progress – 26

Explain the rights of an unpaid seller/vendor.

Lesson end activities:

X entered into a contract for the sale of 100 bags of wheat out of 1000 bags lying in his godown. Unknown to X, the entire stock was destroyed by fire. X declined to deliver. State the legal position.

Let us sum up:

A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price [Sec.4].

The term 'Contract of sale' includes both a 'sale' and 'agreement to sell'.

- Property means the general property in goods, and not merely a special property [Section 2(11)]. General property in goods means ownership of the goods. Special property in goods means possession of goods. Thus, there must be either a transfer of ownership of goods or an agreement to transfer the ownership of goods. The ownership may transfer either immediately on completion of sale or sometime in future in agreement to sell.

  Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement.

- Goods form the subject-matter of a contract of sale. According to Sec 2 (7), '*goods*' means *every kind of movable property* other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Trademarks, copyrights, patent rights, goodwill, electricity, water and gas are all goods.

  The "price" in a contract of sale means the money consideration for sale of goods [Sec. 2 (10)].
- In a contract of sale of goods, conditions and warranties may be express or implied. Express conditions and warranties are those which are expressly provided in the contract. Implied conditions and warranties are those which the law implies into the contract unless the parties stipulate to the contrary

- Transfer of property in goods from the seller to the buyer is the main object of a contract of sale. 'Property in goods' means the ownership of goods whereas 'possession of goods' refers to the custody or control of goods

- Delivery means the voluntary transfer of possession from one person to another.

- A seller of goods is deemed to be an unpaid seller when-
  The whole of the price has not been paid or tendered (offered to be paid)
  A bill of exchange or other negotiable instrument has been received as a conditional payment, and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

UNIT – III

LESSON-27

THE NEGOTIABLE INSTRUMENTS ACT, 1881

CONTENTS

3.27. 1 Meaning and characteristics of Negotiable Instruments
3.27. 2 Essential Characteristic Features of a Negotiable Instrument
3.27. 3 Presumptions as to negotiable instruments
Check your progress: 27

AIMS AND OBJECTIVES

This unit deals with the most important aspect of negotiable instruments which are essential for all types of business transactions. After reading this unit, the students will be able to understand all details regarding negotiable instruments.

This unit aims at providing insight on the following topics

i. Meaning of negotiable instruments
ii. Parties to negotiable instruments
iii. Characteristics of negotiable instruments
iv. Types of negotiable instruments and their characteristic features
v. Endorsement etc.

INTRODUCTION

Negotiable Instrument means a promissory note, bill of exchange or cheque, payable either to order or to the bearer. In business transactions, a clear knowledge of all these are required.

The Negotiable Instruments Act, 1881 came into force on 1st March, 1881. It extends to the whole of India except the State of Jammu and Kashmir.

The Act deals with the law relating to three specific classes of Negotiable Instruments viz. Promissory Note, Bill of Exchange and Cheque. The Act does not apply to:

a. Indian Paper Currency Act, 1871

b. the local usage relating to any instrument in an oriental language (for example, hundies)

But where no custom is established, the Act will apply to Hundies.

3.27.1 MEANING AND CHARACTERISTICS OF NEGOTIABLE INSTRUMENT (SECTION 13)

Meaning of Negotiable Instrument [Section 13(1)]:

Negotiable Instrument means a promissory note, bill of exchange or cheque, payable either to order or to the bearer. But, this definition doesn't explain the features of a Negotiable Instrument. According to Willis, "A negotiable instrument is one the property in which is acquired by anyone who takes it bonafide, and for value, notwithstanding any defect of title in the person from whom he took it." Thus, a negotiable instrument must possess two features:

i. The right of ownership contained in the instrument can be transferred from one person to another by mere delivery if it is payable to bearer or by endorsement and delivery if payable to order, and

ii. The transferee taking the instrument in good faith and for consideration gets a good title to the same even though the title of the transferor is defective.

(a) **Meaning of Negotiable Instrument Payable to Order [Explanation I to Section 13(1)]**

A promissory note, bill of exchange or cheque is payable to order if, either of the following two conditions is fulfilled:

(a) It must be expressed to be so payable, or

(b) It must be expressed to be payable to a particular person and it must contain words which prohibit transfer or indicate an intention that it shall not be transferable.

(b) **Meaning of Negotiable Instrument Payable to Bearer [Explanation II to Section 13(1)]**

A promissory note, bill of exchange or cheque is payable to bearer if either of the following two conditions is fulfilled.

(a) It must be expressed to be so payable, or

(b) The only or last endorsement must be an endorsement in blank.

Clarification Regarding Negotiable Instruments Payable to the Order of a Specified Person [Explanation III to Section 13(1)]

Where a promissory note, bill of exchange or cheque, either originally or by endorsement, is expressed to be payable to the order of a specified person and not to him or his order, it is nevertheless payable to him or his order at his option. In Raghunath v. Bihari Lal, the document signed by Raghunath stated "I promise to pay you (Bihari Lal) on demand the sum of Rs 7000", it was contended that as the document stated nothing about the amount being payable to the order of a person or to the bearer, it was not a negotiable instrument and hence not a promissory note. Held that even if the amount was payable to a specified person it was a valid promissory note.

Notes:

(i) In addition to a promissory note, bill of exchange or cheque, there may be other negotiable instruments recognised by the usage or custom or other Acts. For example, Share Warrant, Dividend Warrant, Bearer Debenture etc. Free transferability makes these instruments negotiable.

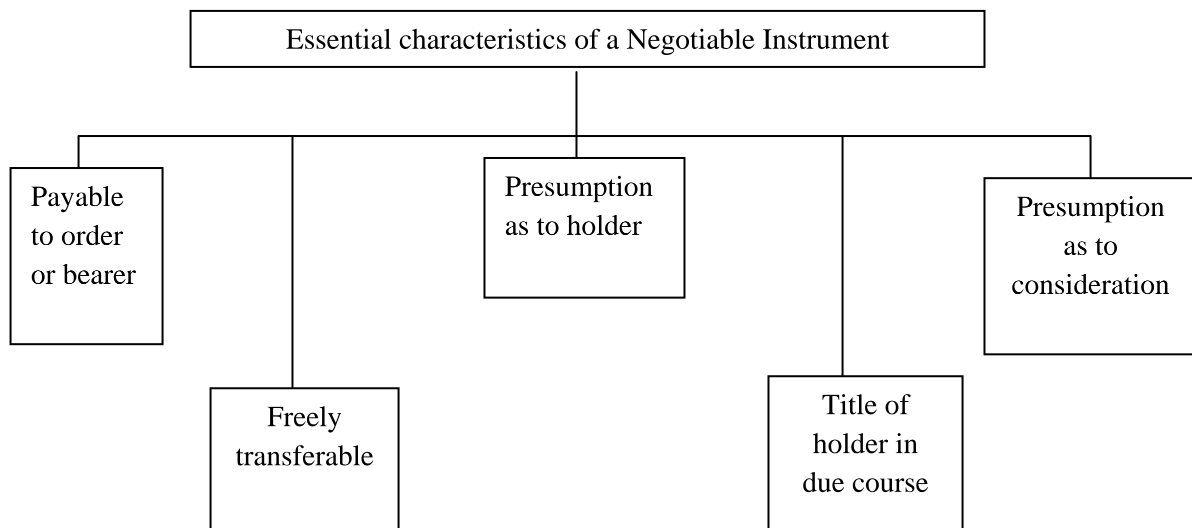
(ii) Railway Receipt (R/R), Bill of Lading, Dock Warrant, Deposit Receipts are not negotiable instruments because they cannot give a better title to the transferee than that of the transferor.

Can there be more than one payee? [Section 13(2)]:

A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one of the two, or some of the several payees.

3.27.2 ESSENTIAL CHARACTERISTIC FEATURES OF A NEGOTIABLE INSTRUMENT

The essential characteristics of a negotiable instrument have been shown below:



a. Payable to order or to Bearer: It must be payable either to order or to bearer.

b. Freely Transferable: An instrument payable to order is negotiable by endorsement and delivery and an instrument payable to bearer is negotiable by mere delivery.

c. Presumption as to Holder: Every holder of a negotiable instrument is presumed to be a holder in due course.

d. Title of Holder in due Course Free from all Defects: A holder in due [i.e., the person who became the possessor of negotiable instrument before maturity, for valuable consideration and in good faith) gets the instrument free from all defects in the title of the transferor.

e. Presumption as to Consideration: Every negotiable instrument is presumed to have been made, drawn, accepted, endorsed, negotiated or transferred for consideration.

3.27.3 PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENTS [SECTION 118]

Until the contrary is proved, the following presumptions shall be made:

a. Of consideration: That every negotiable instrument was made or drawn accepted, endorsed, negotiated or transferred for consideration.

b. As to date: That every negotiable instrument bearing a date was made or drawn on such date.

c. As to time of acceptance: That every accepted bill of exchange was accepted within a reasonable time after its date and before its maturity.

d. As to time of transfer: That every transfer of a negotiable instrument was made before its maturity.

e. As to time of endorsement: That the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

f. As to stamp: That a lost promissory note, bill of exchange or cheque was duly stamped.

g. As to holder in due course: That the holder of a negotiable instrument is a holder in due course except where the instrument has been obtained from its lawful owner, or from any person in lawful custody thereof, by means of an offence or fraud, or has been obtained from the maker or acceptor thereof by means of an offence of fraud, or for unlawful consideration, and the burden of proving that the holder is a holder in due course lies upon him.

h. As to protest: In a suit upon an instrument which has been dishonoured, the Court shall, on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

Check your progress 27:

What are the essentials characteristics of negotiable instruments?

LESSON 28

TYPES OF NEGOTIABLE INSTRUMENTS

CONTENTS

3.28. 1 Types of negotiable instruments

Check your progress: 28

3.28.1 TYPES OF NEGOTIABLE INSTRUMENTS

The various types of negotiable instruments are given below:

Type of instrument	Meaning	Example
1. Bearer instrument [Explanation II to Section 13(1)]	A promissory note, bill of exchange or cheque is payable to bearer if either of the following two conditions is fulfilled: a. It must be expressed to be so payable, or b. The only or last endorsement must be an endorsement in blank. Notes: i. A promissory note cannot be made payable to the bearer. i. A bill of exchange cannot be made payable to bearer on demand. [Section 31 of the Reserve Bank of India Act, 1934] A bearer instrument can be transferred by mere delivery.	“Pay to R or bearer”

2. Order Instrument [Explanation I to Section 13(1)]	A promissory note, bill of exchange or cheque is payable to order if either of the following two conditions is fulfilled: a. It must be expressed to be payable to order, or b. It must be expressed to be payable to a particular person and it must not contain words which prohibit transfer or indicate an intention that it shall not be transferable. Note: An order instrument can be transferred by an endorsement on it and then its delivery.	"Pay to R or order" "Pay to the order of R" "Pay to R"
3. Inland Instrument [section 11]	A promissory note, Bill of exchange or cheque is an inland instrument if both the following conditions are fulfilled: a. It must be drawn in India, b. It must be payable in India, or it must be drawn upon any person resident in India. Notes: i. Protest of inland bill is optional ii. An inland instrument remains inland even if it has been endorsed in a foreign country.	i. "A bill drawn in Delhi on a merchant in Agra and accepted payable in London." ii. "A bill drawn in Delhi on a merchant in London and accepted payable in Agra."
4. Foreign Instrument [Section 12]	An instrument which is not an inland instrument is deemed to be a foreign instrument.	i. "A bill drawn in Delhi on a merchant in London and accepted payable in London."

	Note: Foreign bills must be protested for dishonour if such protest is required by the law of the place where they are drawn [Section 104]	ii. "A bill drawn in London on a merchant in Agra and accepted payable in Agra."
5.Ambiguous Instruments [Section 17]	An ambiguous bill means an instrument which can be construct either as a promissory note or a bill of exchange. Its holder may at his option treat it either as promissory note or a bill. Once he exercises his option, the instrument shall be thence forward treated accordingly.	i. "A bill drawn by an agent acting within his authority upon his principal." ii. "A bill drawn upon a fictitious person."
6. Inchoate Instruments [Section 20]	When one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instrument then in force in India, and either wholly blank or having written thereon an incomplete negotiable instrument, he thereby gives prima facie authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument, for any amount specified therein and not exceeding the amount covered by the stamp. The person so signing shall be liable upon such instrument, in the capacity in which he signed the same, to any holder in due course for such amount.	"A bill drawn payable to ...or order"

	Provided that no person other than a holder in due course shall recover from the person delivering the instrument anything in excess of the amount intended by him to be paid thereunder. Notes: i. The principal of this rule is one of estoppel. ii. The signer is liable if the following conditions are fulfilled: a. The blanks must be filled in and the instrument must be completed. b. The instrument must have been delivered to the transferee. c. The instrument must be stamped one and the stamp affixed must be sufficient to cover the amount filled in the instrument. ii. A holder in due course can recover in excess of the amount intended to be paid by the signer provided the amount is covered by the stamp affixed on the instrument. The provisions of this Section cannot be applied to a cheque which is not required to be stamped.	

7. Instruments payable on demand [Sections 19 and 21]	Instruments payable on demand means the instruments in which no time for payment is mentioned. A cheque is always payable on demand. A promissory note or bill of exchange is payable on demand- a. when no time for payment is specified, or b. when it is expressed to be payable on demand, or at sight or on presentment Notes: i. 'At sight' and presentment means on demand. ii. An instrument payable on demand may be presented for payment at anytime.	i. "1 promise to pay B Rs 500." ii. "I promise to pay B Rs 500 on demand." iii. "Pay B Rs 500 at sight." iv. "Pay B Rs 500 on presentment."
8. Time Instrument	Time instruments mean the instruments in which time for payment is mentioned. A promissory note or bill of exchange is a time instrument when it is expressed to be payable- a. after a specified period b. On a specific day c. After sight d. on the happening of event which is certain to happen	i. "I promise to pay B Rs 500 after 3 months." "I promise to pay ii. Rs 500 on 1st Jan., 1998." iii. "I promise to pay B Rs 500 after sight." iv. "I promise to pay B Rs 500 after C's death."

	Notes: i. The expression 'after sight' means- a. in a promissory note, after presentment for sight b. in a bill of exchange, after acceptance or noting for non-acceptance or protest for non-acceptance. ii. A cheque cannot be a time instrument because the cheque is always payable on demand.	
9. Accommodation Bills	An accommodation bill means a bill which is drawn, accepted without consideration. Provisions relating to such bills: a. The accommodated party cannot, after he has paid the amount of the bill, recover the amount from any person who became a party to the bill for his accommodation [Explanation 1 to Section 43] b. The person who becomes the holder of such a bill in good faith and for consideration, after maturity, may recover the amount from any prior party [Section 59].	X who needs funds, draws a bill on Y who bill and gets the bill discounted with his banker and on due date remits the requisite amount to Y to enable him to meet the bill; such a bill is an accommodation bill.

10. Fictitious Bill	A fictitious bill is a bill in which the name of the drawer or the payee or both is fictitious. When both the drawer and payee of a bill are fictitious persons, the acceptor is liable to a holder in due course if the holder in due course can show that the signature of the supposed drawer and that of the first endorser (payee) are in the same handwriting [Section 42].	i. A bill drawn upon X in favour of P and the drawer is a fictitious person. ii. X had drawn a bill upon Y in favour of Z who is a fictitious person.
11. Documentary Bill	A documentary bill means a bill to which the documents of title to the goods (i.e. Railways Receipt, Bill of Lading) and other documents are attached.	
12. Clean Bill	A clean bill means a bill to which no document relating to the goods (for the transaction of which the bill is being drawn) is attached.	
13. Escrow [Section 46, Para 3]	A negotiable instrument which is delivered conditionally or for a special purpose as a collateral security or for safe custody only and not for the purpose of transferring absolutely the property therein, is called' Escrow'. The liability to pay in case of an escrow does not arise if conditions agreed upon are not fulfilled or the purpose for which the instrument was delivered is not satisfied. This however, does not affect rights of a holder in due course.	

14. Bills in sets [Sections 132 & 133]	Bills of exchange drawn in parts is called bills in sets. Provisions relating to 'Bills in sets' are: a. Each part must be numbered. b. Each part must contain a provision that it shall continue to be payable only so long as the other parts remain unpaid. c. Each part must contain reference to the other parts. d. Each part must be signed and delivered by the drawer. e. All the parts of the whole set need not be accepted. f. When a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such parts if it were a separate bill. As between holders in due course of different parts of the same set, he who first acquired title to his part is entitled to the other parts and the money represented by the bill. [Section 133]	

Check your progress 28:

Enumerate the types of negotiable instruments.

LESSON-29

PROMISSORY NOTE [SECTION 4]

CONTENTS

3.29. 1 Essential Characteristics of a Promissory Note
3.29. 2 Parties to a Promissory Note
Check your progress: 29

According to Section 4 of the Negotiable Instruments Act, 1881, "A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money only to the order of a certain person or to the bearer of the instrument."

Notes:

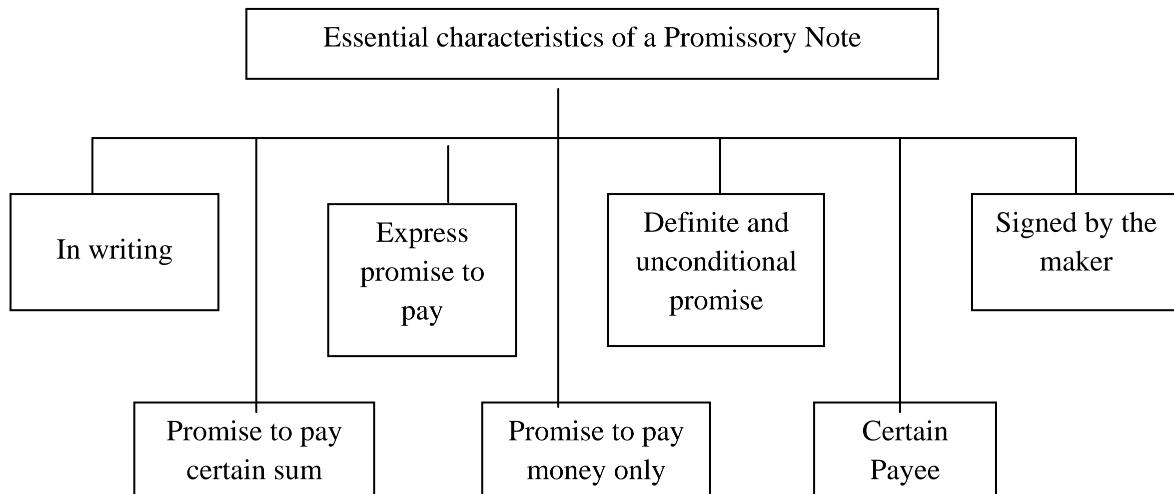
i. A promissory note may be payable on demand or after a definite period of time

ii. The words "or to the bearer of the instrument" have become inoperative in view of the provision contained in Section 31(2) of the Reserve Bank of India Act, which provides that no person in India other than Reserve Bank of India or the Central Government can make or issue promissory note payable to the bearer of the instrument.

iii. A bank note or currency note is not a promissory note because it is money itself.

3.29.1 ESSENTIAL CHARACTERISTICS OF A PROMISSORY NOTE

The essential characteristics of a promissory note are as follows:



i. In writing: It must be in writing. In other words, an oral promise does not make a promissory note since it is not an instrument.

   Example: A promises to pay B a sum of Rs. 500 on telephone. This promise will not make a promissory note because it is not in writing.

ii. Express promise to pay: There must be an express promise to pay and not mere acknowledgement of indebtedness.

Example: State with reasons whether each of the following instruments is a Promissory note or not:

(a) “Mr B, I owe you Rs 500.”

(b) “We have received the sum of Rs 500 in cash from Mr B.”

(c) “We have received the sum of Rs 500 in cash from Mr B. This amount will be repaid on demand”.

(d) “We promise to pay Mr B a sum of Rs 500”.

Solution: Cases (a) and (b): These instruments are not promissory notes because there is no express promise to pay. These instruments are merely acknowledgements of indebtedness.

Cases (c) and (d): These instruments are promissory notes because there is an express promise to pay.

In Akbar Khan vs. Attar Singh (ILR 1936, 17 Lahore, 557 DC) a document was made with the following words, "This receipt is hereby executed by B ... for Rs 43,000 received from A, the amount to be payable after two years. Interest @ Rs 5 % to be charged”. Held the instrument was not a Promissory Note as it was a mere receipt stating the terms of repayment.

iii. Definite and unconditional promise: The promise must be definite and unconditional. It may be noted that a promise to pay is not conditional if it depends upon an event which is certain to happen but the time of its occurrence may be uncertain.
   Example: State with reasons whether each of the following instruments is a Promissory Note or not.

a. "I promise to pay B Rs 500 seven days after my marriage withMadhuri or Sridevi”.

b. "I promise to pay B Rs 500 on D's death provided D leaves me enough to pay that sum".

c. “I promise to pay Rs 500 on D's death".

Solution:

Cases (a) and (b): These instruments are not promissory notes because the promise to pay is not unconditional. In Beardsley vs. Baldwin (1741) 93 IR 1094, a written undertaking to pay a certain amount within a specified time after defendant's marriage was not recognised as a promissory note because possibly the defendant may never marry and the sum may never become payable.

Case (c): This instrument is a promissory note because the promise to pay is unconditional as it is certain that D will die.

iv. Signed by the maker: It must be signed by the maker. The purpose of signature is to authenticate the instrument. The signatures can be made on any part of the instrument.

v. Promise to pay certain sum: The promise must be to pay a certain sum. Negotiable Instruments are meant for free circulation and if their value is not clearly mentioned on the instruments, their circulation would be materially impeded. The sum payable is also certain in the following cases:

a. Where it is payable along with interest and either the amount of interest itself or the rate of interest is given.

b. Where it is payable at a specified rate of exchange.

c. Where it is payable by instalments with a provision that a default being made in payment, the unpaid balance shall become due [Section 5].

Example:
State with reasons whether each of the following instruments is a Promissory Note or not.

a. "I promise to pay 8 Rs 500 and all other sums which shall be due to him."

b. "I promise to pay B Rs 500, first deducting thereout any money which he may owe me".

c. "I promise to pay B Rs 500 along with interest thereon."

Solution:
The aforesaid instruments are not promissory notes because the sum payable is not certain.

vi. Promise to pay money only: The payment must be in money and money only.

Example: State with reasons whether each of the following instruments is a Promissory note or not:

a. "I promise to deliver to B 1000 kg of paddy."
b. "I promise to pay B Rs 500 and deliver 1000 kg of paddy."
c. "I promise to pay B Rs 500 and to deliver to him by black horse on 1st January next".

Solution: The aforesaid instruments are not promissory notes because the payment is not in money and money only.

vii. Certain payee: The payee must be certain. Where the payee is designated by description only (say captain of a particular cricket team, president of a particular club, manager of a particular bank), the promissory note is valid if the payee can be ascertained by evidence.

A promissory note cannot be made payable to the maker himself. Such a note is invalid. However, it becomes a valid promissory note if it is endorsed by the maker because it then becomes payable to bearer (if endorsed in blank) or it becomes payable to the endorsee or his order (if endorsed specially).

Requirements under the Indian Stamp Act, 1899: A promissory note must be stamped with adhesive stamp or engrossed on a stamp paper of proper value. This requires the cancellation of such stamp which may be done by writing his name across the stamp or initials with the date of his writing or in any other effectual manner.

Notes:

i. The omission of consideration received, place and date will not invalidate the instrument.

ii. An undated instrument will be treated as having been made on the date of delivery.

iii. An ante-dated or post-dated instrument is not invalid.

3.29.2 PARTIES TO A PROMISSORY NOTE

There are two parties to a promissory note as under:

i. The maker: The person who makes the promissory note is called the maker.

ii. The payee: The person to whom or to whose order the payment is to be made is called the payee.

Check your progress 29:

What are promissory notes?

LESSON-30

BILL OF EXCHANGE [SECTION 5]

CONTENTS

3.30. 1 Essential Characteristics of a Bill of Exchange
3.30. 2 Parties to a Bill of Exchange
3.30. 3 Acceptance
3.30. 4 Essentials of a Valid Acceptance
3.30. 5 Types of Acceptance
3.30. 6 Effect of Qualified Acceptance
Check your progress: 30

According to Section 5 of the Negotiable Instruments Act, 1881, "A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of a certain person or the bearer of the instrument." Thus, a bill is an order by a creditor upon his debtor requiring him to pay the money to the person specified.

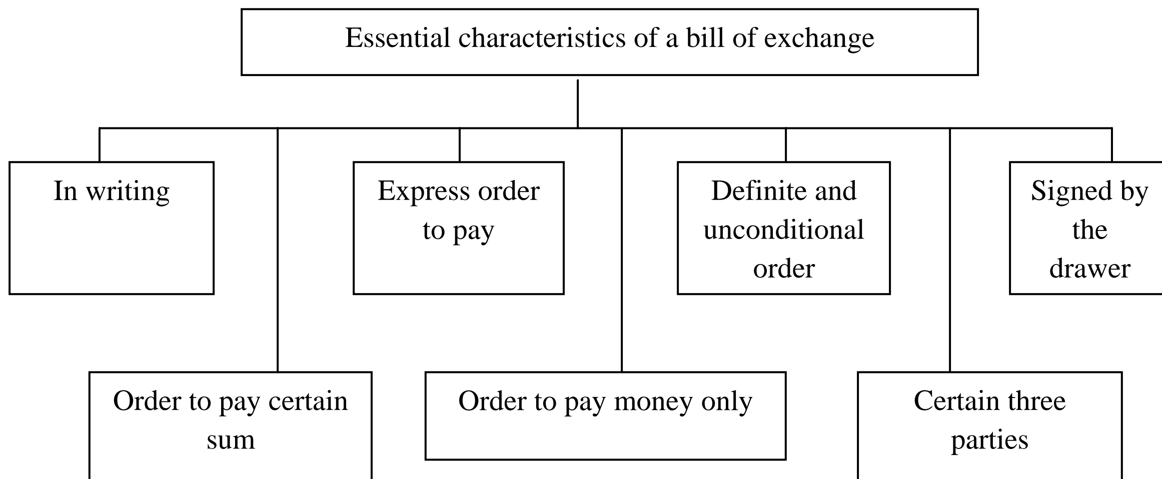
Notes:

i. A bill of exchange may be made payable to bearer on demand or after a definite period of time.

ii. A bill of exchange cannot be made payable to bearer on demand because Section 31 of the Reserve Bank of India Act prohibits the issue of such bills of exchange.

3.30.1 ESSENTIAL CHARACTERISTICS OF A BILL OF EXCHANGE

Essential characteristics of a bill of exchange are as follows:



1. In writing: It must be in writing
2. Express order to pay: There must be an express order to pay and not a mere request to pay.
3. Definite and unconditional order: The order must be definite and unconditional.
4. Order to pay certain sum: The order must be to pay a certain sum.
5. Order to pay money only: The order must be to pay money only.
6. Certain three parties: The three parties (i.e., drawer, drawee and payee) must be certain and must be mentioned in the instrument. It may be noted that the drawer and payee can be the same person but the drawer and drawee cannot be the same person.
7. Signed by the drawer: It must be signed by the drawer.

3.30.2 PARTIES TO A BILL OF EXCHANGE

There are three parties to a bill of exchange as under:

i. Drawer: The person who draws a bill of exchange is called the drawer.

ii. Drawee: The person on whom the bill of exchange is drawn is called the drawee. He is also called as an acceptor of the bill.

iii. Payee: The person named in the instrument to whom or to whose order the money is directed to be paid by the instrument, is called the payee.

3.30.3 ACCEPTANCE

Meaning of Acceptance

It is only the bill of exchange which requires acceptance. A bill is said to be accepted when the drawee (i.e., the person on whom the bill is drawn), after putting his signature on it, either delivers it or gives notice of such acceptance to the holder of the bill or to some person on his behalf. After the drawee has accepted the bill, he is known as the acceptor.

However, acceptance is not necessary to make a valid bill. If a bill is not accepted, it does not become invalid. It only becomes dishonoured by non-acceptance.

Acceptance in Case of Bills in Sets

Where a bill is drawn in sets, the acceptance is required to be put on one part only.
Where the drawee signs his acceptance on two or more parts, he may become liable on each of them respectively.

3.30.4 ESSENTIALS OF A VALID ACCEPTANCE

The essentials of a valid acceptance are as follows:

Written: It must be in writing and not oral.

Signed: It must be signed by the drawee personally or through his duly authorised agent.

On the bill: It must be on the bill whether on the face or on the back of the bill.

Delivered: The drawee must either deliver the bill or give notice of his acceptance to the holder of bill or to some person on his behalf.

3.30.5 TYPES OF ACCEPTANCE

Acceptance may be either general or qualified.

General Acceptance: An acceptance is said to be general when the drawee assents without qualification to the order of the drawer.

Qualified Acceptance: An acceptance is said to be qualified when the drawee assents subject to qualification. It may be noted that an acceptance will not be treated as a qualified acceptance unless the qualification is expressed on the bill in the clearest language. The qualification may relate to an event, amount, place, time, etc. According to Section 86, an acceptance is qualified under the following circumstances:

a. where it is conditional declaring the payment to be dependent on the happening of an event therein stated;

b. Where it undertakes the payment of part only of the sum ordered to be paid;

c. where no place of payment being specified on the order, it undertakes the payment at a specified place, and not otherwise or elsewhere; or where, a place of payment being specified in the order, it undertakes the payment at some other place and not otherwise or elsewhere;

d. where it undertakes the payment at a time other than that at which under the order it would be legally due;

e. where it is not signed by all drawees who are not partners.

3.30.6 EFFECT OF QUALIFIED ACCEPTANCE

Where the acceptance is qualified, the holder of a bill, may at his option, treat the bill as dishonoured and after giving due notice of dishonour, sue the drawer and prior endorsers. If he accepts a qualified acceptance without obtaining the consent of all prior parties thereto, all prior parties whose consent is not obtained are discharged as against the holder and those deriving title from him.

Examples of qualified acceptance

i. Accepted payable when in funds.
ii. Accepted payable on giving up bill of lading.
iii. Accepted payable when a cargo consigned to me is sold.
iv. A bill drawn for Rs 1,000 accepted for Rs 900 only.
v. Accepted payable at Delhi only where no place of payment is specified in the order.
vi. Accepted payable at Delhi only where the place of payment specified in the order was Bombay.
vii. Accepted payable 4 months after date where the bill drawn as payable months after date.
viii. Accepted by A, B and C where drawees were A, B, C and D who were not partners.

Distinction between Bill of Exchange and Promissory Note
A Bill of Exchange differs from a Promissory Note in the following respects:

Basis of distinction	Bill of exchange	Promissory note
1. No. of parties	There are three parties drawer, drawee and payee.	There are two parties - maker and payee.
2. Promise/order	It contains an unconditional order given by a creditor to a debtor.	It contains an unconditional promise given by a debtor to a creditor.
3. Nature of liability	The liability of the drawer is secondary and conditional.	The liability of the maker is primary and absolute.
4. Acceptance	It requires acceptance to become a valuable instrument.	It does not require any acceptance since it is a valuable instrument right from the beginning.
5. Same identity of payer and payee.	The drawer and payee may be the same person.	The maker and payee cannot be the same person.

6. Payable to bearer.	It can be payable to bearer. It cannot be drawn as payable to bearer on demand.	It cannot be payable to bearer.
7. Protest for dishonour	It requires the protesting for dishonour.	It does not require any protesting.
8. Notice of dishonour	Notice of dishonour must be given to all persons (including drawer) liable to pay.	Such notice is not required to be given to the maker.

Check your progress 30:

Write about a bill of exchange.

LESSON-31
CHEQUE [SECTION 6]

CONTENTS

3.31. 1 Essential Characteristics of a Cheque
3.31. 2 Parties to a Cheque
3.31. 3 Crossing of a Cheque
3.31. 4 Bouncing or dishonour of Cheque
Check your progress: 31

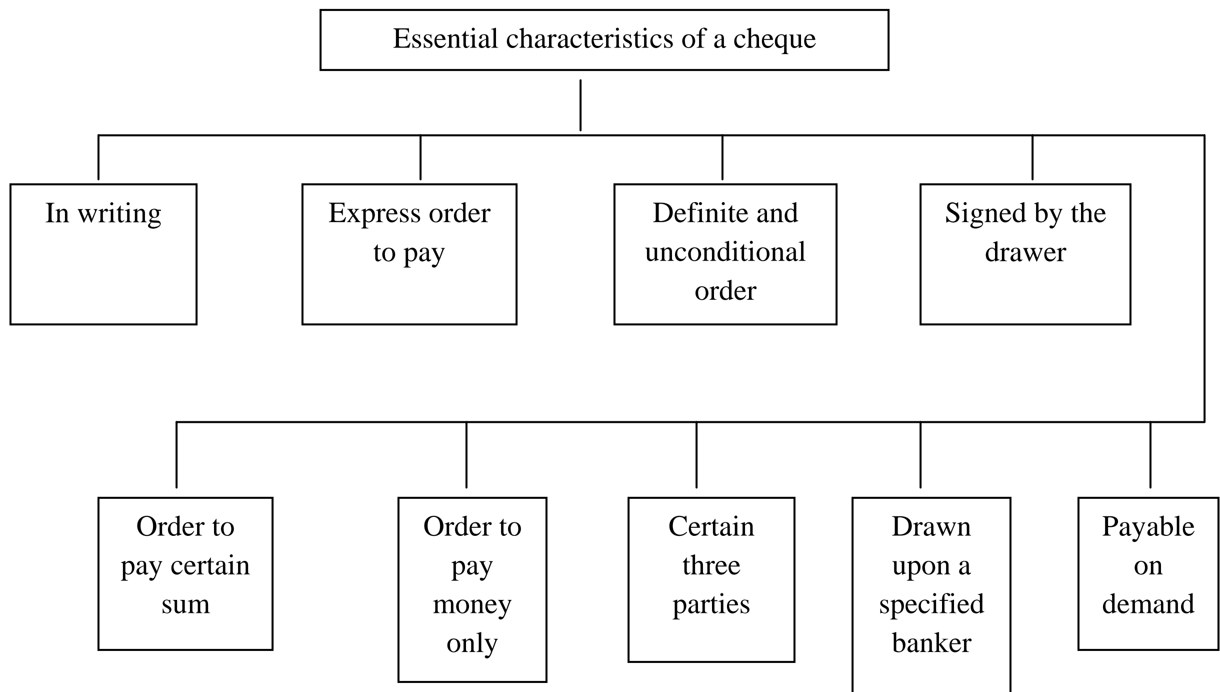
A cheque is a bill of exchange which is

(a) drawn upon a specified banker, and

(b) payable on demand.

3.31.1 ESSENTIAL CHARACTERISTICS OF A CHEQUE

Essential characteristics of a cheque have been shown below:



i. In writing: It must be in writing.
ii. Express order to pay: There must be an express order to pay and not request to pay.
iii. Definite and unconditional order: The order must be definite and unconditional.
iv. Signed by the drawer: It must be signed by the drawer.
v. Order to pay certain sum: The order must be to pay a certain sum.
vi. Order to pay money only: The order must be to pay money only.
vii. Certain three parties: The three parties (i.e., drawer, drawee and payee) be certain and must be mentioned in the instrument.

In addition to the aforesaid essentials of a bill of exchange, the cheque must also satisfy the following two requirements:

1. Drawn upon a specified banker: It must always be drawn upon a banker.
2. Payable on demand: It must always be payable on demand.

Thus, all cheques are bills of exchange in the sense that these have all the essential elements of a bill of exchange. But all bills of exchange are not cheques because a bill of exchange becomes a cheque only when it satisfies the aforesaid two additional requirements.

Notes:

i. No acceptance of a cheque is required.
ii. Cheque is not required to be stamped.

3.31.2 PARTIES TO A CHEQUE

There are three parties to a cheque as under:

a. Drawer: The person who draws the cheque is called the drawer.
b. Banker: The bank on which the cheque is drawn is called the drawee,
c. Payee: The person in whose favour the cheque is drawn is called the payee. The payee may be a third party or the drawer himself.

Distinction between a Cheque and a Bill of Exchange

Basis of distinction	Cheque	Bill of Exchange
1. Drawer	It is always drawn on a bank	It can be drawn upon an individual as well as a bank
2. Payable on demand	It is always payable on demand	It need not always be payable on demand
3. Payable to bearer on demand	It can be drawn payable to bearer on demand	It cannot be payable to bearer on demand
4. Acceptance	It does not require an acceptance.	It requires an acceptance of the drawee.
5. Stamp	It does not require a stamp.	It requires a stamp.
6. Three days of grace	It is not entitled to three days of grace.	A bill, unless payable on demand is entitled to three days of grace.
7. Crossing	It can be crossed.	It cannot be crossed.
8. Form	Its fixed form is honoured by a banker.	There is no fixed form.
9. Notice of dishonour	Notice of dishonour is not required.	Notice of dishonour is usually required.
10. Countermanding	It can be revoked by countermanding of payment.	It cannot be countermanded.

3.31.3 CROSSING OF A CHEQUE [SECTIONS 123 to 131A]

Crossing: The Crossing of a Cheque is an instance of an alteration which is authorised by the Act. A cheque is said to be crossed when it bears across its face two parallel transverse lines which are usually drawn on the left hand top corner of the cheque.

Purpose of Crossing: The purpose of Crossing is to direct the drawee (banker) to pay the amount of cheque only to a banker so that the party who receives the payment of the cheque can be easily traced.

Types of Crossing: There are two types of Crossing, viz. general crossing and special crossing.

Notes:

Only the cheques can be crossed. The promissory notes or bills of exchange cannot be crossed.

A general crossing can be converted into special crossing but a special crossing cannot be converted into general crossing. If the holder converts the special crossing into general crossing by striking out the banker's name, it will amount to material alteration.

A special crossing can be made only once except where the second special crossing is made by a banker to another banker to act as an agent of the former.

Where a cheque contains special crossing to more than one banker, then the paying banker shall refuse to make the payment of the same.

Who can Cross a Cheque after Issue [Section 125]

A cheque may be crossed after its issue in the following manner:

Case	Right to cross
1. Where a cheque is uncrossed	The holder may cross it generally or specially
2. Where a cheque is crossed generally	The holder may cross it specially by adding the name of same banker.
3. Where a cheque is crossed generally or specially	The holder may add the word 'Not Negotiable'.
4. Where a cheque is crossed specially	The banker to whom it is crossed may again cross it specially to another banker (his agent) for collection.

Can a Cheque be Crossed Specially more than once? [Section 127]
A cheque cannot be crossed more than once. It is only a special crossing which may require a second crossing. This is allowed only when a Banker in whose favour a crossing is made, can once again cross it in favour of his agent for collection. Therefore, a banker is, except for the above stated case, prohibited to make payment on a cheque bearing more than one crossing.

3.31.4 BOUNCING OR DISHONOUR OF CHEQUES

A cheque is said to be bounced or dishonoured by non-payment when the drawee of the cheque makes default in payment upon being duly required to pay the same.

Liability of Drawee on Dishonour of a Cheque [Section 31]:

The drawee of a cheque must compensate the drawer for any loss or damage caused by non-payment if the following three conditions are fulfilled:

i. If the drawee has sufficient funds of the drawer in his hands;

ii. If the funds are properly applicable to such payment;

iii. If the drawee is duly required to pay the cheque.

Note : The drawee (i.e., paying banker) is liable to drawer and not to any person.

Liability of Drawer on Dishonour of a Cheque [Section 138]

On dishonour of a cheque, the drawer is punishable with imprisonment for a term not exceeding 1 year or with fine not exceeding twice the amount of a cheque or with both if the following conditions are fulfilled:

a. If the cheque was drawn to discharge a legally enforceable debt or other liability;

b. If the cheque is returned by the bank unpaid due to insufficiency of funds in the account of drawer;

c. If the cheque has been presented to the bank within a period of six months from the date on which it is drawn or within the period of its validity, whichever is earlier;

d. If the payee or the holder in due course of the cheque has made a demand for the payment of the said amount of money by giving a notice, in writing, to the drawer of the cheque within fifteen days of the receipt of information by him from the bank regarding the return of the cheque as unpaid; and

e. If the drawer of such cheque has failed to make the payment of the said amount of money to the payee or to the holder in due course of the cheque, within fifteen days of the receipt of the said notice.

Cases in which a Banker must Refuse to Honour a Customer's Cheque:

A banker must refuse to honour a customer's cheque in the following cases:

i. Stop payment: When the banker receives instructions from the customer not to honour (i.e. stop payment) a particular cheque issued by him.

ii. Garnishee order: When the banker receives a Garnishee Order, i.e., a prohibiting order by any court attaching the money in the customer's account.

iii. Death: When the banker receives a notice of the death of his customer.

iv. Insolvency: When the banker receives a notice of the insolvency of his customer.

v. Insanity: When the banker receives a notice of the insanity.

vi. Assignment: When the banker receives a notice of assignment of his credit balance from a customer.

vii. Defect in title: When the banker suspects or has reason to believe that the title of the person presenting the cheque is defective.

viii. Loss of Cheque: When the banker receives a notice of loss of cheque from his customer.

ix. Material alteration: When there is a material alteration in the cheque and such alteration has not been authenticated by his customer by putting his signature.

x. Different signature: When the signature of the drawer does not tally with the specimen signature kept by the bank.

xi. Notice of closure: When the banker receives a notice in respect of closure of account.

xii. Irregular endorsement: When there is an irregular endorsement.

Cases in which a Banker may refuse to Honour a Customer's Cheque:

i. A banker may refuse to honour a customer's cheque in the following cases: Insufficient funds: When funds in the customer's account are insufficient to honour the cheque presented.

ii. Funds not applicable: When funds in the customer's account are not applicable for the cheque presented.

iii. Presentment at different branch: When the cheque is presented at the branch other than the branch where the customer who has issued the cheque, has the account.

iv. Presentment after banking hours: When the cheque is presented after the banking hours.

v. Stale cheque: When the cheque is presented after 6 months from the date of its issue.

vi. Post dated cheque: When the cheque is presented before the actual date on which it is written to be payable.

vii. Undated cheque: When the cheque is undated [Griffith v. Dalton (1940)].

Meaning of Holder [Section 8]

A person is called holder of a negotiable instrument if he satisfies the following two conditions:

a. he must be entitled to the possession of the instrument in his own name; and

b. he must be entitled to receive/recover the amount due on the instrument from the parties liable under the instrument.

Thus, Holder means the bearer of the bearer instrument and the endorsee or payee of the order instrument. He must be a *dejure* holder and not a *defacto* holder. He should be the owner thereof at law, whatever be his position in equity. It may be noted that under English Law, actual possession of the instrument is essential to be a Holder but such physical possession is not necessary under the Negotiable Instruments Act.

Example X advanced Rs. 10,000 to Y who executed a promissory note in the name of Z a benamidar. On Maturity Y failed to pay the amount due and X brought an action against Y. It was held that X could not recover the amount because he was not entitled to the promissory note in his own name. [Sarjoo Prasad v. Ramapayari Debi]

Note: Only a holder can bring a legal action to recover the amount due on the instrument.

Holder in case of loss or destruction :

Where a note, bill or cheque is lost or destroyed, its holder is the person who was entitled to the instrument in his name at the time of such loss or destruction. For example, the finder of a lost instrument payable to bearer or a person in wrongful possession of such instrument is not a holder. Similarly, an agent holding an instrument for his principal will also not be a holder of it although he may receive its payment.

Holder in due Course [Section 9]:

A person is called a holder in due course if he satisfies the following conditions:

i. He must be a holder.

ii. He must have become, for consideration, either the possessor of the instrument if payable to bearer, or payee or endorsee thereof if payable to order. Such consideration must not be unlawful and need not be adequate.

iii. He must have obtained the instrument before its maturity. He must become the holder before the amount becomes payable there on. A person taking the bill or note on the day on which it becomes payable is not a holder as he takes it after it has become payable since the instrument may be discharged at any time on that day.

iv. He must have obtained the instrument in good faith, i.e. without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

v. He must receive the instrument complete and regular on the face of it, e.g. in Arab Bank Ltd. vs. Ross (1952) 2Q.B.216; the payee in the promissory note was described as F and F.N. & Co., whereas endorser endorsed the note as F and F.N. omitting the words 'company'. Held, the endorsee did not constitute to be a holder in due course since the endorser and the payee appeared to be different person making the instrument not complete and regular on the face of it.

Check your progress 31:

What are the essential characteristics of cheque?

LESSON-32
MATURITY OF A NEGOTIABLE INSTRUMENT
[SECTIONS 22 to 25]

CONTENTS

3.32. 1 Capacity and authority of a person to be a party to a negotiable instrument
3.32. 2 Negotiation and Assignment
Check your progress: 32

Meaning of Maturity [Section 22]

The Maturity of a promissory note or bill of exchange is the date on which it falls due.

Days of Grace [Section 22]

Every instrument payable otherwise than on demand is entitled to three days of grace.

Calculation of Date of Maturity [Sections 23 to 25]

The date of maturity in various cases is calculated as under:

Case	Date of maturity
1. In case of bill or note payable on a specified day.	Third day after the specified day.
2. In case of bill or note payable on stated number of months after date [Section 23]	Third day after the date on which the period of the bill or note shall expire. Note: The period shall expire on that day of the month which corresponds with the day on which the bill is dated. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the last day of such a month.
3. In case of bill payable on a stated number of months after sight and accepted for honour [Section 23]	Third day after the date on which the period of the bill or note shall expire. Note: The period shall expire on that day of the month which corresponds with the day on which the bill is accepted for honour. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the last day of such month.

4. In case the day on which a note or bill is at maturity, is a public holiday [Section 25]	The next preceding business day. Note: The expression public holidays includes Sundays and any other day declared by the Central Government by notification in the Official Gazette to be a public holiday.
5. In case the day on which a note or bill is at maturity is an emergency/unforeseen public holiday.	The next following business day.

Note: The day on which the bill/note is drawn or presented for acceptance, sight or the day on which the event happens, must be excluded. [Section 24]

3.32.1 CAPACITY AND AUTHORITY OF A PERSON TO BE A PARTY TO A NEGOTIABLE INSTRUMENT [SECTIONS 26 to 28]

Meaning of Capacity:

Capacity here means competence to contract so as to bind oneself.

Who can Bind and be Bound [Section 26]:

Every person capable of contracting, according to the law to which he is subject, may bind himself and be bound by the making, drawing, acceptance, endorsement, delivery and negotiation of a promissory note, bill of exchange or cheque.

Position of Minor [Section 26]:

A minor may draw, enndorse, deliver and negotiate such instrument so as to bind all parties, except himself.

In other words, the instrument will be valid and binding on all parties except the minor.

Note: It is the estate of a minor (not the minor as person) which is liable for debts arising out of 'necessaries' supplied to minor.

Can Liability Under Instrument be Incurred through an Agent [Section 27]: Every person capable of binding himself or of being bound, may so bind himself or be bound by a duly authorised agent acting on his behalf.

Does an Agent's General Authority include an Authority to Accept or Endorse a Bill [Section 27]:

A general authority to transact business and to receive and discharge debts does not confer upon an agent the power of accepting or endorsing bills of exchange so as to bind his principal.

Does an Agent's Authority to Draw a Bill include an Authority to Endorse [Section 27]:

An authority to draw bill of exchange does not of itself impart an authority to endorse.

Liability of an Agent [Section 28]:

An agent who signs his name on a promissory note, bill of exchange or cheque without indicating thereon that he signs as an agent, or that he does not intend thereby to incur personal responsibility, is liable personally on the instrument.

Exception to the aforesaid rule:

An agent is not persona1ly liable to those who induced him to sign upon the belief that the principal only would be held liable.

Note:

The mere signature of an agent in his own name with the word 'agent' added does not exempt him from personal liability [Liverpool Bank vs. Walter]

3.32.2 NEGOTIATION AND ASSIGNMENT [SECTIONS 14,47, 48, 60]

Meaning of Negotiation [Section 14]:

An instrument is said to be negotiated when a promissory note, bill of exchange or cheque is transferred to any person so as to constitute that person the holder of the instrument.

Thus, the essence of the negotiation is that it must be made with the intention of transferring a title of the instrument to the transferee.

Meaning of Assignment:

An instrument is said to be assigned when a promissory note, bill of exchange or cheque is transferred by means of a written and registered document under the provisions of the Transfer of Property Act, 1882. The person who transfers his right to recover the payment of a debt is called an assignor and the person to whom such rights are transferred is called an assignee. The assignee takes the instrument subject to all equities which arise between the party liable and the assignor. Thus, the assignee gets the rights of the assignor only. He does not rights of a holder in due course.

Check your progress 32:

What is negotiation and what is assignment?

LESSON-33

ENDORSEMENT [SECTIONS 15, 16, 50, 51, 52, 56]

CONTENTS

3.33. 1 Meaning of Endorsement

3.33. 2 Kinds of Endorsements

Check your progress: 33

3.33.1 MEANING OF ENDORSEMENT [SECTION 15]

The process of transferring an instrument is called an endorsement. An endorsement means signing the negotiable instrument on the back or face thereof or on a slip of paper (called allonge) annexed thereto for the purpose of negotiation. The person who endorses the instrument is called the "endorser" and the person in whose favour the instrument is endorsed is called the 'endorsee'.

Who may Endorse/Negotiate [Section 51]:

Every sole maker, drawer, payee or endorsee, or all of several joint makers, drawers, payees or endorsees of a negotiable instrument may endorse and negotiate the same if the negotiability of such instrument has not been restricted or excluded as mentioned in Section 50 [Section 51]. In other words, a stranger (i.e., a person other than those stated above) cannot endorse a negotiable instrument. If a stranger endorses it, the endorsement is void and he cannot be made liable as endorser. [Thakersey vs. Kishandas]

A maker or drawer of payee or endorsee may endorse or negotiate an instrument only if he is a holder thereof [Explanation to Section 51].

Essential Requirements of a Valid Endorsement The essential requirements of a valid endorsement are as follows:

i. It must be on the back or face of instrument or on a slip of paper (called allonge) annexed thereto.
ii. It must be signed by the endorser.
iii. It must be completed by the delivery of the instrument.
iv. It must be made by the holder of the instrument.

3.33.2 KINDS OF ENDORSEMENTS

General Endorsement or Blank Endorsement:

An endorsement is said to be in blank if the endorser signs his name only. An instrument endorsed in blank becomes payable to the bearer thereof even although it was originally payable to order.

Special Endorsement or Full Endorsement:

An endorsement is said to be full if the endorser

i. signs his name, and
ii. adds a direction to pay the amount to or to the order of a specified person.

Restrictive Endorsement:

An endorsement is said to be restrictive if it restricts/ excludes the right of further negotiation.

Thus, in case of restrictive endorsement, the endorsee does not become the owner of the instrument as in case of other endorsement.

Partial Endorsement:

An endorsement is said to be a partial endorsement when it purports to transfer only a part of the amount of the instrument. A partial endorsement is invalid.

Exception: Where an instrument has been paid in part, the fact of the part payment may be endorsed on the instrument and it may then be negotiated for the residue.

Conditional Endorsement or Qualified Endorsement:

An endorsement is said to be a conditional endorsement if it limits or negatives the liability of the endorser.

Check your progress 33:

What are the kinds of endorsements?

LESSON-34

MATERIAL ALTERATION [SECTIONS 20, 49, 87, 89, 125]

CONTENTS

3.34. 1 Meaning of Material Alteration

3.34. 2 Effect of Material Alteration
Check your progress: 34
Lesson End Activities

3.34.1 MEANING OF MATERIAL ALTERATION

An alteration can be called a material alteration if it alters or attempts to alter the character of the instrument and affects or is likely to affect the contract which the instrument contains or is evidence of. Thus, it totally alters the business effect of the instrument. It makes the instrument speak a language other than that intended.

Material alteration	Non-material alteration
1. Alteration of date of instrument(e.g.,if a bill dated Ist May,1998) is changed to a bill dated 1st June, 1998.	1. Conversion of instrument payable to order into one payable to bearer.
2. Alteration of time of payment(e.g.,if a bill payable three months after date is changed to a bill payable four months after date).	2. Conversion of instrument payable to bearer into order.
3. Alteration of place of payment (e.g., if a bill payable at Delhi is changed to bill payable at Bombay).	3. Elimination of the words' or order' from an endorsement.
4. Alteration of amount payable (e.g., if a bill for Rs 1000 is changed to a bill for Rs 2000)	4. Addition of the words 'on demand' to a note in which no time or payment is expressed.
5. Conversion of blank endorsement into special endorsement	
6. Addition of a new party to an instrument.	
7. Alteration of one of the clauses of the instrument containing a penal action.	

Material Alterations Authorised by the Act [Sections 20, 49, 125]:

The following material alterations have been authorised by the Act and do not require authentication:

i. Filling blanks of inchoate instruments [Section 20]
ii. Conversion of a blank endorsement into an endorsement in full [Section 49]
iii. Crossing of cheques [Section 125]

3.34.2 EFFECT OF MATERIAL ALTERATION [SECTIONS 87 AND 88]

An instrument which is materially altered becomes void against all persons who were parties to it at time of alteration and did not consent to it unless such alteration was made in order to carry out the common intention of the original parties.

The effect of material alteration on liability of various parties is summarised:

Persons	Effect
1. Persons who were parties at the time of alteration and did not consent to alteration.	Such persons are altogether discharged from liability under that instrument. Such persons shall not be liable even to a bonafide purchaser of the instrument having no notice of alteration.
2. Persons who were parties at the time of alteration and consented to alteration and persons who became parties to the instrument subsequent to the alteration.	Such persons continue to be liable under that instrument.

Protection to a Person Paying a Materially Altered Instrument [89]:

The payer of a materially altered instrument is discharged from all liability on the instrument if the following two conditions are fulfilled:

(a) The alteration must not be apparent; and

(b) The payment must be made in due course.

Example:

X draws a cheque for Rs. 1000 and Y, a holder without the consent of X, alters the figure 1000 into 10,000 and makes the instrument look like a cheque drawn for Rs 10,000. The banker who pays such cheque in due course is discharged from all liability under the cheque since the alteration was not apparent.

Check your progress 34:

What is material alteration?

Lesson end activities:

A bill is drawn as “pay to X or order the sum of ten thousand rupees”. In the margin the amount stated is Rs.1,000. Discuss the legal position.

THE INDIAN PARTNERSHIP ACT, 1932

AIMS AND OBJECTIVES

This unit aims at enabling the students

i. To understand the concept of partnership
ii. The regulations applicable to partnership firms
iii. The types of partners
iv. Registration of firms
v. Relations of firms
vi. Rights and duties of partners and
vii. Dissolving partnership firms

INTRODUCTION

Partnership is one of the specific contracts which as a part of the Indian Contract Act, 1872. In 1930, however, the provisions relating to partnership contract were repealed and a separate Act called the Indian Partnership Act, 1932 was passed which is in force till today. It extends to the whole of India except the State of Jammu and Kashmir.

LESSON-35

NATURE OF PARTNERSHIP

CONTENTS

3.35. 1 Definition of Partnership

3.35. 2 Characteristics of Partnership

3.35. 3 Formation of Partnership

3.35. 4 Partners, Firm, Firm Name

Check your progress: 35

The law of partnership is contained in the Indian Partnership Act, 1932, which came into force on 1st October, 1932. Prior to the enactment of this Act, it was embodied in Chapter XI of the Indian Contract Act, 1872. It was, however, found that the provisions relating to partnership, as contained in the Contract Act, were not exhaustive. Hence the present Partnership Act. The Act is substantially based on the English Law on the subject as contained in the Partnership Act, 1890. The main principles are the same but at places certain alterations have been made to adapt the law to the peculiar conditions prevailing in India. The most important change brought about by the Act is the provision for the registration of firms.

A contract of partnership is a special contract. Where the Partnership Act is silent on any point, the general principles of the law of contract apply (Sec. 3).

In chapters 5-1 to 5-3, unless otherwise stated, Sections referred to are those of the Indian Partnership Act, 1932.

3.35.1 DEFINITION OF PARTNERSHIP

Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all (Sec. 4, Para 1). Persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm' (Sec. 4, Para 2).

3.35.2 CHARACTERISTICS OF PARTNERSHIP

If we analyse the definition of partnership, the following essential characteristics stand out:

1. Association of two or more persons:

There should be at least two competent persons to form a partnership. As regards the maximum number of partners in a firm, Sec. 11 of the Companies Act, 1956 provides that the number of partners in a firm carrying on banking business should not exceed ten and in any other business twenty. If the number of partners exceeds this limit, the partnership becomes an illegal association. It ceases to be a partnership if the number gets reduced to one by any reason.

The term ‘person’ as used in Sec. 4 does not include a firm [Duli Chand etc. vs. Commr. of Income-tax, A.I.R. (1956) S.C. 354]. This is because a firm is not a separate legal entity. As such two partnership firms cannot enter into partnership, though all the partners of the two

firms may form a partnership out of their separate firms provided their numbervdoes not exceed the statutory limit. A company is a 'person' within the meaning of Sec. 4 [M.M. Pulimood vs. Registrar of Firms, (1987) 61 Comp. Cas. 209 (Ker.)]. It may, being an entity distinct from its members, enter into a contract of partnership if it is authorised by its Memorandum of Association [Steel Bros. & Co. Ltd. vs. Commr. of Income tax, A.I.R (1958) S.C. 315].

2. Agreement:

The partnership relation is one of contractual nature. It arises from contract and not from status (Sec. 5, para 1), as agreement between the partners is the basis of this contract. The agreement may be express (i.e., oral or written) or implied. Implied agreement may be inferred from the course of dealing or the conduct of the parties. The agreement may be for a fixed period, or for the execution of a particular adventure, or it may give option to the partners to withdraw from the partnership at any time. Partnership is thus created by contract; it does not arise by operation of law (as in the case of co-owners) or from status (as in the case of a Joint Hindu Family) or from inheritance. Partnership agreement, like any other contract, must have all the essential elements of a valid contract.

3. Business:

A partnership can be formed only for the purpose of carrying on some business. ‘Business’ includes every trade, occupation and profession [Sec. 2 (b)]. The word ‘business’ generally conveys the idea of a running business involving numerous transactions. Besides that a person may become a partner with another in a particular adventure. The business to be carried on by the firm must be legal.

4. Sharing of profits:

The object of partnership must be to make profit. Profit means net profit, i.e., excess of returns over outlays, the excess of what is obtained over the cost of obtaining it. Profit must be distributed among the partners in an agreed ratio. If any person claiming to be a partner is deprived of his right to share in the profits of the business, he is not a partner as his carrying on the business is n profit. But the reverse is not necessarily true. A person may share in the profits of partnership, but still he may not be a partner. The sharing of profit also involves sharing of loss which in fact is negative profit. But as between the partners, it may be agreed that one or more of the partners shall not be liable for losses.

5. Mutual agency:

The business of partnership may be carried on by all the partners or any of them acting for all. A partner is both an agent (in the sense that he can bind by his acts the other partners) and the principal (in the sense that he can be bound by the acts of the partners). The question whether a person is or is not a partner depends in nearly all cases upon whether he has the authority to act for those who are admittedly partners and whether those admitted partners have the authority to act for him.

Law of partnership - an extension of the law of agency

The partnership business may be carried on by all the partners or any of them acting for all. Thus, the relationship of principal and agent is established among partners and this relationship is governed by the law of agency. Sec. 18 also provides that, subject to the provisions of the Partnership Act, a partner is the agent of the firm for the purposes of the business of the firm. The leading case on the point is:

Cox v. Hickman, (1860) H.L.C. 268. A trader carried on his business under the supervision of his creditors. The object of carrying on the business was to pay them off out of the profits of the

business. Held, no partnership existed between the trader and the creditors. It was rightly observed in this case.

"The law as to partnership is undoubtedly a branch of the law of the principal and agent. The liability of one partner for the acts of his co-partners is in truth the liability of a principal for the acts of his partners when two or more persons are engaged as partners in an ordinary trade, each of them has an implied authority from the others to bind all others by contracts entered into according to usual course of business in that trade........... " .

A partner assumes a two-fold character:

He is an agent of the firm so far his dealings with the outside world for the purposes of the business of the firm are concerned. He can bind the firm by his acts provided

a. the acts are within the scope of his authority

b. they are done in the firm's name and

c. they are done for the purposes of the business of the firm.

He is a principal so far as the other partners are concerned. The relation between the partners inter se (i.e., between r among themselves) is that of principals.

Example:

A, B and C are partners in a business. D, an outsider, deals with the firm through A. As between A and D, A is the principal. But as between A, B and C, A is also the agent of

Band C. As such A, B and C can all sue D. D can also sue A, B and C. Furthermore, A is accountable to B and C because he is in this transaction an agent of B and C.

To sum up : the law of partnership governing relations of the partners inter se and with the outside world is an extension of the law of principal and agent.

3.35.3 FORMATION OF PARTNERSHIP

A partnership is based on an agreement. The partnership agreement may be made orally or in writing or may be implied from the course of dealing among partners. However, all the essential elements of a 'valid contract' must be present. There must be free and genuine consent of the parties who must be competent to contract. The object of the partnership should be lawful and other legal formalities should be complied with. But the following two points should be noted in this connection:

i. Minor partner:

   A minor may be admitted to the benefits of partnership with the consent of all the other partners.

ii. Consideration:

   As no consideration is required to create an agency (Sec. 185 of the Indian Contract Act. 1872), no consideration is required to create partnership which is an extension of the law of agency.

Partnership deed:

The agreement creating partnership may be express (i.e., oral or written) or implied, and the latter may be inferred from the conduct or the course of dealing of the parties or from the circumstances of' the case. However, it is in the interest of the partners that the agreement must be in writing. The document which contains this agreement is called partnership deed. It usually contains provisions relating to the nature and the principal place of business, the name of the firm, the names and addresses of the partners, the duration of the firm, profit sharing ratio, interest on capital and drawings, valuation of goodwill on the death or retirement of a partner, management, accounts, arbitration, etc. The deed must be duly stamped as required by the Indian Stamp Act, 1889.

Who may be partners?

A contract of partnership may be entered into by every person who is competent to enter into a contract (Sec. 11 of the Indian Contract Act, 1872].

Alien enemy:

A alien enemy cannot enter into a contract of partnership with an Indian subject. An alien friend can do so.

Minor:

A minor cannot become a partner in a firm but with the consent of all the other partners, he may be admitted to the benefits partnership.

Person of unsound mind:

A person of unsound mind is not competent to enter into a contract of partnership.

Corporation:

A corporation, i.e., a registered company, can enter into a contract of partnership as a single individual but not as a group of individuals comprising it [Sri Murugan Oil Industries (Pvt.) Ltd. vs. A.U. Suryanarayana Chettiar, (1963) 33 Comp, Cas. 833 (Mad.)].

3.35.4 PARTNERS, FIRM, FIRM NAME

Persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm', and the name under which the business is carried on is called the 'firm name'[Sec. 4, Para 2]. The firm name is only a short way of expressing the names of all the partners. The partners of a firm may carry on business under any name and style which they please to adopt. But this is subject to the following two limitations:

A firm name shall not contain any words expressing or implying the sanction, approval or patronage of the Government. The State Government may, however, signify its consent to the use of such words by a firm as part of its name by order in writing [Sec. 58 (3)].

The law safeguards the trade names and goodwill of other persons who are already in existence, The mere fact that a firm has already been doing business under a certain name does not prevent a new firm from adopting it. But if the name is used with a fraudulent intention, the law will intervene. The firm may be restrained from the adoption of such name by injunction.

Partnership and firm

Partnership is merely an abstract legal relation between the partners. It is, in other words, an abstract thing. A firm is a collective name for all the partners. It is a concrete thing. Partnership may be styled as the invisible tie binding the partners together. The firm is the visible body (collective group) of those partners who are thus bound together.

Legal status of firm:

In mercantile or commercial usage, a firm is deemed to have existence distinct from the partners constituting it. In some of the continental countries also a firm is recognised as a person distinct from the partners constituting it. But in England and India, a firm is not a distinct legal entity apart from the partners constituting it [Malabar Fisheries Co. vs.

Commr. of Income-tax, Kerala, AI.R. (1980) S.C. 176). Unlike a company which is a corporate body, it is not regarded as a person in the eyes of the law. 'Firm' is only a compendious description, i.e., abridged name for the individuals who compose it [Munshi Ram vs. Chhehrata Municipality, AI.R. (1979) S.C.1250] ; it is not a legal entity. Its name is merely an abbreviated or abridged name for all its partners. The rights and obligations of a firm are really the rights and obligations of the partners who compose the firm.

Do the same partners in two different firms constitute one firm ?

An agreement between the partners of a firm to carry on a business and share its profits may be followed by a separate agreement between the same partners to carry on another business and share the profits therein. It will depend on the intention of the partners whether they intend to-

i. constitute two separate partnerships and therefore two distinct firms or

ii. extend merely a partnership, originally constituted to carry on one business, to the carrying on of another business.

The intention of the partners will have to be decided with reference to the terms of the agreement and all the surrounding circumstances including evidence as to the interlacing (entangling together) or interlocking (uniting together) of management, finance and other incidents of the respective businesses (Deputy Commr. of Sales Tax vs. K. Kelukutty, A.I.R (1985) S.C. 1143].

Check your progress 35:

Define partnership

LESSON-36

TEST OF PARTNERSHIP

CONTENTS

3.36. 1 Test of partnership

3.36. 2 Duration of partnership

Check your progress: 36

3.36.1 TEST OF PARTNERSHIP

In order to determine the existence of partnership between a group of persons, the definition in Sec. 4 is used as a test, i.e., one must look to the agreement between them. If the agreement is to share the profits of a business, and the business is carried on by all or any of them acting for all there is partnership, otherwise not. The difficulty arises when there is no specific agreement constituting partnership among the partners, or the agreement is such as does not specifically speak of partnership. In such a case, we have to refer to Sec. 6 which embodies the rule laid down in the case of Cox vs. Hickman, (1860) H.L.C. 268.

Real relation is the basis:

The general principle which serves as a guide to determine whether a group of persons does or does not constitute partnership as laid down in Sec. 6 is as follows:

“In determining whether a group of persons is or is not a firm, or whether a person is or is not a partner in a firm, regard shall be had to the real relation between the parties, as shown by all relevant facts taken together.”

Determination of real relation:

The real relation between the parties is to be determined from all the facts, i.e., the written or verbal agreement, surrounding circumstances at the time when the contract was entered into, conduct of the parties, and other relevant facts, e.g., books of account, correspondence, evidence of employees, etc. These are not considered individually to ascertain the existence of partnership, but are taken collectively and their cumulative effect is taken into consideration. In effect it is the substance of the thing, and not the form, that has to be looked to. The parties may expressly state in a document that they are not partners but they may turn out to be partners in the eyes of the law, when all the other facts are taken into account. Again, a statement by the parties in a document that they are partners may not necessarily constitute them partners in law.

Mixed question of law and fact:

Whether a genuine partnership exists or not is a mixed question of law and fact. The fact that a partner was entitled to a fixed percentage of profits of the firm only and not to share its losses and he was excluded from operating bank accounts of the firm, were inconsequential in determination of the question [Helper Girdharbhai vs. Saiyed M.M. Kadri, (1987) 3 S.S.C.538].

Cases where no partnership relation: Sec. 6 enumerates, in its two Explanations, cases where the partnership relation does not exist. These cases are:

Joint owners sharing gross returns:

Joint owners of property sharing profits or gross returns arising from the property do not become partners (Explanation 1 to Sec. 6).

Example:

A and B jointly purchased a tea shop. Each of them contributed a half of the expense incurred for the purchase of pottery and utensils. They then leased out the shop and shared the rent equally. Held, they were co-owners and not partners [GovindNair vs. Maga, AI.R. (1933) Rang. 120].

If, however, co-owners start a business with a view to sharing profits of the business, they become partners.

Sharing of profits:

The sharing of profits is prima facie a strong evidence of partnership but the fact that there is sharing of profits between some persons will not automatically make them partners. Therefore, receipt by a person of a share of the profits of a business, or of a payment contingent upon the earning of profits or varying with the profits earned by the business does not of itself make him a partner with the persons carrying on the business. In particular, there is no partnership-

Where a person has lent money to persons engaged or about to engage in business and receives a rate of interest varying with the profit.

Example:

A advanced money to two merchants who agreed to carry on the business subject to the control of A in several respects. A was to receive a commission of 20 per cent on all profits. Held, there was no partnership [Mollow March & Co.vs. The Court of Wards (1872) L.R. 2 C.P. 419).

Where a Servant or agent is engaged in a business, and receives his remuneration as a share of profit:

Example:

A, a contractor for loading and unloading rail wagons, appointed a servant to manage it. The servant was to receive 75 per cent of the profits and was to bear all losses, if any. Held, the servant was the agent of A and not his partner [Munshi Abdul Latif vs. Gopeshwar, A.I.R. (1933) Cal. 204).

Where the widow or child of a deceased partner receives a portion of the profit:

Where a person has sold his business along with its goodwill and receives a portion of the profits in consideration of the sale (Explanation 2 to Sec. 6).

Although the sharing of profits of a business is a strong test of partnership, yet whether the relation of partnership does or does not exist must depend upon the real intention and conduct of the parties.

The real test is mutual agency:

To conclude, one may say that the true test of 'partnership is not the sharing of profits by a person or the contribution of capital or the holding of a particular property jointly, but whether the business is carried on by him or by another on his account so that there is a mutual agency between them. If relation of principal and agent exists between the parties constituting a group, formed with a view to earn profits a business, we can say that there is partnership.

Who are not partners (Sec.5, Para 2):

The following persons (in addition to those already discussed) are not partners:

i. The members of a Hindu undivided family carrying on family business as such

ii. A Burmese Buddhist husband and wife carrying on business as such.

3.36.2 DURATION OF PARTNERSHIP

The partners may, at the time when they enter into partnership agreement, fix the duration of the partnership or may say nothing about it. In the former case, the partnership is called a partnership for a fixed term, and in the latter case, a partnership-at-will. Sometimes, a partnership is formed for the purpose of carrying on a particular adventure or undertaking. In such a case, it is called a particular partnership.

Partnership for a fixed term:

In this case, the partnership is entered into for a fixed period of time. When the fixed period is over, it comes to an end. The partners may, however, continue to carry on the business after the expiry of the fixed period. In such a case the mutual rights and duties of partners remain the same as they were before the expiry of fixed period and the partnership becomes partnership-at-will [Sec. 17 (b)].

Partnership-at-will:

Where no provision is made by contract between the partners for the duration of the partnership, or for the determination of the partnership, the partnership is "partnership-at-will" (Sec. 7). It may be dissolved by any partner by giving a notice in writing to all other partners of his intention to dissolve the firm. When such a notice is given, the firm is dissolved as from the date mentioned in the notice as the date of dissolution or, if no date is so mentioned, as from the date of communication of the notice (Sec. 43) [Bodheshwar vs. Jatindra Nath,A.I.R. (I976) Gau. 12]. A partner-at-will can undoubtedly name a date as from which the firm would stand dissolved, but that date can, in no case, be prior to the date of issue of his notice [V.V.P. Thangarau vs. K. V. Perumal, A.I.R. (l980) Mad. 7] . The notice should be an unambiguous intimation of a final intention to dissolve partnership, and should be served on all the other partners. Notice once given cannot be withdrawn unless all the other partners agree to it [Jones v. Lloyd. (1874) I.R. 18 Eq. 265].

Particular partnership:

When a person becomes a partner with another person or persons in a particular adventure or undertaking, such a partnership is known as "particular partnership" (Sec. 8). It comes to an end as soon as that adventure is completed. If it is continued after the completion of that adventure for which it was entered into, it becomes partnership-at-will. In such a case, rights and liabilities of the partners in respect of the other adventures are the same as those in respect of the original adventure or undertaking [Sec. 17 (c)].

Check your progress 36:

How can partnership be tested?

LESSON-37

REGISTRATION OF FIRMS

CONTENTS

3.37. 1 Procedure for registration

3.37. 2 Time of registration

3.37. 3 Effects of non-registration

3.37. 4 Alterations

Check your progress: 37

The Partnership Act does not provide for the compulsory registration of firms. It has left it to the option of the firms to get themselves registered. But indirectly, by creating certain disabilities from which an unregistered firm suffers, it has made the registration of firms compulsory. Sec. 69 deals with such disabilities. These disabilities are such that, sooner or later, every firm has to get itself registered. However, registration does not create partnership; it is only a reliable evidence of the existence of partnership. It also affords protection to outsiders dealing with the firm.

3.37.1 PROCEDURE FOR REGISTRATION (SECS. 58 AND 59)

The registration of a firm may be effected at any time by filing an application in the form of a statement, giving the necessary information, with the Registrar of Firms of the area. Sec. 57 empowers a State Government to appoint Registrars of Firms for the purposes of the Partnership Act and define the areas within which they shall exercise their powers and perform their duties.

The application for registration of a firm shall be accompanied by the prescribed fee. It shall state:

(a) the name of the firm ;

(b) the place or principal place of business of the firm

(c) the names of other places where the firm carries on business

(d) the date when each partner joined the firm

(e) the names in full and permanent addresses of the partners

(f) the duration of the firm.

The statement shall be signed by all the partners or by their agents specially authorised in this behalf [Sec. 58 (1)]. It shall also be verified by them in the prescribed manner [Sec. 58 (2)].

When the Registrar is satisfied that the above provisions have been duly complied with, he shall record an entry of the statement in the Register of Firms (maintained by Registrar of Firms in respect of each registered firm for recording the necessary information relating to that firm) and file the statement (Sec. 59). He shall then issue under his hand a certificate of registration. Registration is effective from the date when the Registrar files the statement and makes entries in the Register of Firms and not from the date of presentation of the statement to him [Commr. of Income-Tax vs. Jayalakshmi R. & O. Mars, A.I.R. (197 1) S.C.1015]. Registration to a firm under Sec. 59 cannot be declined for the reason of a company being a partner of the firm [M.M. Pulimood vs. Registrar of Firms, (1987) 61 Comp. Cas. 209 (Ker.)].

3.37.2 TIME OF REGISTRATION

As to the time of the registration of a firm, there is no definite provision in the Act. Sec. 69 (2), however, lays down that no suit to enforce a right arising from a contract can be instituted in any Court by or on behalf of a firm against any third party unless the firm is registered and the persons suing are or have been shown in the Register of Firms as partners in the firm. In other words, no suit by an unregistered firm is competent and the only course open to the Court is to dismiss it [Malhotra & Co. vs. Ramesh Mistri, AI.R. (1971) Punj. 212]. The point of time contemplated in Sec. 69 (2) is the time of the institution of the suit. That is to say, the firm must be a registered firm by the date of the institution of the suit [Shanker Housing Corporation vs. Mohan Devi, A.I.R. (1978) Delhi 255). This means before any suit is filed in a Law Court, registration must be effected. Subsequent registration does not cure initial defect at the time of the institution of the suit. The right course in such a case is to withdraw the suit from the Court, get the firm registered and then file a fresh suit.

3.37.3 EFFECTS OF NON-REGISTRATION (SEC. 69)

1. Suits between partners and firm:

A person suing as a partner of an unregistered firm cannot sue the firm or any partners of the firm to enforce a right arising from a contract or conferred by the Partnership Act. He can do so if -

i. the firm is registered, and
ii. the person suing is or has been shown in the Register of Firms as a partner in the firm [Sec. 69 (1)].

2. Suits between firm and third parties:

An unregistered firm cannot sue a third party to enforce a right arising from a contract until

i. the firm is registered and
ii. the names of the persons suing appear as partners in the Register of Firms [Sec. 69 (2)].

A plaint filed by an unregistered firm in contravention of Sec. 69 (1) and (2) is treated as a void plaint (Abani Kanta Pal, In the matter of, A.I.R (1986) Cal. 143]. This view finds support from a decision of the Supreme Court In Loonkaran Sethia vs. Ivan E. John, AI.R. (1977) S.C. 336.

In Shreeram Finance Corpn. vs. Yasin Khan, AI.R. (1989) S.C. 1769, a suit by the appellants (partners) was hit by the provisions of Sec. 69 (2), as on the date when the suit was filed, two of the partners shown as partners as per relevant entries in the Register of Firms were not, in fact, partners, one new partner had come in and two minors had been admitted to the benefits of the partnership firm regarding which no notice was given to the Registrar of Firms. Thus, the persons suing, namely, the current partners as on the date of the suit were not shown as partners in the Register of Firms. As such the suit was not maintainable in view of the provision of Section. 69 (2).

3. Claim of set-off:

An unregistered firm or any partner thereof cannot claim a set-off in a proceeding instituted against the firm by a third party to enforce a right arising from a contract, until the registration of the firm is effected (Sec. 69 (3)]. This right of set-off, however, is not affected if the claim of set-off does not exceed Rs. 100 in value [Sec. 69 (4) (b)].

Non –registration, however, does not affect-

1. The right of a firm or partners, of a firm having no place of business in India.
2. The right to any suit or claim of set-off not exceeding Rs. 100 in value.
3. The right of a partner to sue for the dissolution of the firm, or for the accounts of the dissolved firm, or for share of the property of the dissolved firm. (D.C. Upreti vs. B.D. Karnatak, AI.R. (1986) All. 32].

   It should be noted that this disability of a partner to sue disappears with the dissolution of the firm.
4. The powers of an Official Assignee, Receiver or Court to realise the property of an insolvent partner of an unregistered firm.
5. The right of a third party to proceed against an unregistered firm or any of its partners.
6. The right of an unregistered firm to enforce a right arising otherwise than out of a contract (Sec. 69 (3) and (4)].

It should however be noted that a decree passed in a suit filed by an unregistered firm is not a nullity and where the plea of non-registration is not raised in the suit itself, it cannot be raised in a separate suit [Kalyan Sahai vs. Firm Lachminarain, AI.R. (1951) Raj. 11].

3.37.4 ALTERATIONS

If any alteration relating to the following matters takes place in the case of a registered firm, a statement or intimation is to be sent to the Registrar of Firms for incorporating the necessary change in Register of Firms.

1. Change in the name of the firm or in location of the principal place of business of the registered firm (Sec. 60).
2. Closing and opening of branches (Sec. 6I).
3. Change in names and addresses of partners (Sec. 62).
4. Change in the constitution of the firm and its dissolution or election of a minor partner on attaining majority to continue as partner or sever his connection (Sec. 63).

Penalty for false particulars (Sec. 70):

If any person supplies incomplete information to the Registrar or signs any statement containing false or incomplete information to be supplied Registrar, he is punishable with imprisonment which may extend to three months, or with fine, or with both.

Inspection of Register of Firms and documents and grant of copies (Secs. 66 and 67):

The Register of Firms shall be open to inspection by any person on payment of such fee as may be prescribed [Sec. 66 (1)]. Further all statements, notices and intimations filed with the Registrar shall be open to inspection subject to prescribed conditions and payment of prescribed fees [Sec. 66 (2)]. The Registrar shall also, on application, furnish to any person on payment of the prescribed fee a certified copy of any entry in the Register of Firms (Sec. 67).

Rules of evidence (Sec. 68):

Any statement, notice or intimation recorded with the Registrar by any person shall be a conclusive proof against him of any fact therein stated. The third parties can, however, challenge the fact of a statement and prove that it is false and is based on misrepresentation or fraud.

Check your progress 37:

What are the effects of non-registration of partnership firms?

LESSON-38
RELATIONS OF PARTNERS

CONTENTS

3.38. 1 Relations of partners to one another

3.38. 2 Rights of a partner

3.38. 3 Duties of a partner

Check your progress: 38

3.38.1 RELATIONS OF PARTNERS TO ONE ANOTHER

The relations of the partners of a firm to one another are usually governed by the agreement among them. Such agreement may be express or may be implied from the course of dealing among them. It may be varied by consent of all them, and such consent may be expressed or may be implied by a course of dealing [Sec. 11 (I)]. Where there is no specific agreement or where the agreement is silent on a certain point, the relations of partners to one another as regards their rights and duties are governed by Secs. 9 to 17 of the Partnership Act.

3.38.2 RIGHTS OF A PARTNER

1. Right to take part in business:

The partnership agreemenit usually provides the mode of the conduct of the business. Subject to any such agreement between the partners, every partner has a tight to take part in the conduct of the business [Sec. 12 (a)]. This is based on the general principle that partnership business is the common business of all the partners. But where a partner neglects or refuses to perform his duties and the burden of performing such duties for the conduct of the business falls on other partners, the other partners have a right to compensation [Krishnamachariar vs. Sankara, (1921) AP.C. 91].

2. Right to be consulted:

Every partner has an inherent right to be consulted in all matters affecting the business of the partnership and express his views before any decision is taken by the partners.

Where there is any difference of opinion among the partners as to ordinary matters connected with the business, it may be settled, subject to contract between the partners, by a majority of the partners. The majority of the partners in exercising their power must act in good faith, and before the matter is decided every partner must have expressed his

opinion. If the partners are equally divided those who forbid the change must have their way. But as to important matters concerning the nature of the business, no change may be effected without the consent of all the partners. [Sec.12 (c)]. Thus, for example, no change can be made in the nature of the business, nor can the place of the business be changed nor the sale of the business effected, unless all the partners agree to it .

3. Right of access to accounts:

Subject to contract between the partners, every partner has a right to have access to and inspect and copy any of the books of the firm [Sec. 12 (d)]. A minor partner may have access to and inspect any of the accounts of the firm [Sec. 30 (2)] but not 'books'.

4. Right to share in profits:

In the absence of any agreement, the partners are entitled to share equally in the profits earned and are liable to contribute equally to the losses sustained by the firm [Sec. 13 (b)].

5. Right to interest on capital:

The partnership agreement may contain a clause as to the right of the partners to claim interest on capital at a certain rate. Such interest, subject to contract between the partners, is payable only out of profits, if any, earned by the firm [Sec. 13 (c)].

6. Right to interest on advances:

Where a partner makes, for the purposes of the business of the firm, any advance beyond the amount of capital, he is entitled to interest on such advance at the rate of six per cent per annum [Sec. 13 (d)]. Such interest is not only payable out of the profits of the business but also out of the assets of the firm.

7. Right to be indemnified:

A partner has authority, in an emergency to do all such acts for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence, in his own case, acting under similar circumstances. Such acts of the partner bind the firm (Sec.21). If as a consequence of any such act, the partner incurs any liability or makes any payment, he has a right to be indemnified [Sec. 13 (e)].

8. Right to the use of partnership property:

Subject to contract between the partners, the property of the firm must be held and used by the partners exclusively for the purposes of the business of the firm. No partner has a right to treat it as his individual property (Sec. 15). If a partner uses the property of the firm directly or indirectly for his private purpose, he must account to the firm for the profits which he may have earned by the use of that property.

9. Right of partner as agent of the firm:

Every partner for the purposes of the business of the firm is the agent of the firm (Sec. 18). And subject to the provisions of the Indian Partnership Act, the act of a partner which is done to carry on, in the usual way, business of the kind carried on by the firm, binds the firm (Sec. 19).

10. No new partner to be introduced:

Every partner has a right to prevent the introduction of a new partner unless he consents to that or unless there is an express term in the contract permitting such introduction [Sec. 31 (1)]. This is because partnership is found on mutual trust and confidence.

11. No liability before joining:

A person who is introduced as a partner into a firm is not liable for any act of the firm done before became a partner [Sec. 31 (2)].

12. Right to retire:

A partner has a right to retire

a. with the consent of all the other partners, or

b. in accordance with an express agreement between the partners, or

c. Where the partnership is at will, by giving notice to all the other partners of his intention to retire [Sec. 32 (1)].

13. Right not to be expelled:

A partner has a right not to be expelled from the firm by any majority of the partners, save in the exercise in good faith of powers conferred by the contract between the partners [Sec. 33 (1)].

14. Right of outgoing partner to share in the subsequent profits:

Where a partner has died, or has ceased to be a partner by retirement, expulsion, insolvency or any other cause, the surviving or continuing partners may carry on the business with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate. In such a case, legal representative of the deceased partner or the outgoing partner, in the absence of a contract to the contrary, is entitled, at his option, to-

a. such share of the profits as is proportionate to his share in the property of the firm, or

b. interest at the rate of 6 per cent per annum on the amount of his share in the property of the firm (Sec. 37).

3.38.3 DUTIES OF A PARTNER

Partnership is a contract of uberrimae fidei. The partners must act with utmost good faith as the very basis of partnership is mutual trust and confidence. According to Sec. 9, which deals with the general duties of partners, partners are bound-

a. to carry on the business of the firm to the greatest common advantage,

b. to be just and faithful to each other, and

c. to render true accounts and full information of all things affecting the firm or any partner or his legal representative.

The other duties are spread over the Partnership Act. These duties are summed up as under:

1. To carry on business to the greatest common advantage:

Every partner is bound to carry on the business of the firm to the greatest common advantage. He is bound in all transactions affecting the partnership, to do his best in the common interest of the firm. He must share with other partners any benefit which he may have been able to obtain from other people and in which the firm is in honour and conscience entitled to participate.

Example:

B and C were partners in a business as sugar refiners. C was authorised to buy sugar for the firm. He, without B's knowledge supplied to the firm his own sugar at the market price. He had bought the sugar at a lower price and thus made a considerable profit. Held, he must account to the firm for the profit made [Bentley vs. Craven (1853) 18 Beav. 75].

2. To observe faith:

Partnership is a fiduciary relation. Every partner must be just and faithful, and observe utmost good faith towards every other partner of the firm. Good faith requires that he shall not obtain a private advantage at the expense of the firm. He is bound, in all transactions affecting the partnership, to do his best in the common interest of the firm.

3. To indemnify for fraud:

Every partner is bound to indemnify the firm for any loss caused to it by his fraud in the conduct of the business of the firm. This is an absolute duty of a partner and no partner can act himself out of it (Sec. 10). The innocent partners of the firm are, however, liable to third parties for the fraud of any of the partners. But they can proceed to claim damages against the partner who has committed the fraud.

4. To attend diligently:

Subject to contract between the partners, it is the duty of every partner to attend diligently to his duties in the conduct of the business of the firm [Sec. 12 (b)], and to use his knowledge and skill to the common advantage of all the partners.

5. Not to claim remuneration:

A partner is not entitled to recover any remuneration in any form for taking part in the conduct of the business of the firm. It is, however, usual to allow some remuneration to the working partners provided there is a specific agreement to that effect. [Sec. 13 (a)].

Where a pardanashin lady was a partner, it was held that it was just and reasonable that some allowance must be made to the other partners for the trouble they took in running the business of the firm [G. Krishna vs. S. Mukhi, 16 C.W.N. 299]. Similarly, where undue labour and extra trouble is imposed on one partner by another partner's wilful neglect of the business to which he ought to attend, he is entitled to compensation [Krishnamachariar vs. Sankara, (1921) A.P.C. 91].

6. To share losses:

It is the duty of every partner to contribute to the losses of the firm. In the absence of any agreement to the contrary, partners are bound to contribute equally to the losses sustained by the firm [Sec. 13 (b)]. An agreement to share profits implies an agreement to share losses also.

7. To indemnify for wilful neglect:

Every partner is, subject to contract between the partners, bound to indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm [Sec.13 (f)]. The firm is, however, liable to the third persons for the wilful neglect or fraud of any of the partners.

8. To hold and use property of the firm exclusively for the firm:

It is the duty of every partner of the firm to hold and use the property firm exclusively for the purposes of the business of the firm. The partners may agree differently but, in such a case, there should be a specific agreement to that effect (Sec. 15).

9. To account for personal profits:

If a partner derives any benefit, without the consent of the other partners, from partnership transactions (or from any use by him of the partnership property, name or business connection), he must account for it and pay it to the firm. This is because the relationship between partners is a fiduciary relationship and no partner is entitled to make any personal profit [Sec. 16 (a)].

Example:

A, B, and C carry on business of partnership as merchants. D, to whom they send goods for sale on commission, secretly allows C a share in the commission which he received in consideration of C using his influence to send consignments to him. A and B come to know of the secret share of C. They can compel C to render account to the firm for the money so received by him.

10. To account for profits in competing business:

A partner must not carry on any business of the same nature as competing with that of the firm. If he does that, he is bound to account for and pay to the firm all profits made by him in that business. This is, however, subject to contract between the partners [Sec. 16 (b)].

Example:

A and B are partners in a business which consists of supplying meat to the government. Subsequently, it is found out that A is engaged with C in the supplying of meat to the same government.

A is bound to account to the firm for the profits so made by him (Loch vs. Lynam, (1854) 4 Ir. C.R. 188).

11. To act within authority:

Every partner is bound to act within the scope of his actual or implied authority (Sec. 19 (1)]. Where he exceeds the authority conferred on him and the firm suffers a loss, he shall have to compensate the firm for any such loss.

12. To be liable jointly and severally:

Every partner is liable, jointly with all the other partners and also severally, for all the acts of the firm done while he is a partner (Sec. 25).

13. Not to assign his rights:

A partner cannot assign his rights and interest in the firm to an outsider so as to make him the partner of the firm. He can, however, assign his share of the profit and his share in the assets of the firm (Sec. 29).

Check your progress 38:

What are the rights of partners?

LESSON-39

DISSOLUTION OF FIRM

CONTENTS

3.39. 1 Dissolution of firm

3.39. 2 Dissolution of partnership

3.39. 3 Dissolution without the order of the court

3.39. 4 Dissolution by court

3.39. 5 Rights and liabilities of partners on dissolution

Check your progress: 39

Lesson End Activities

Let Us Sum Up

The ‘dissolution of partnership’ between all the partners of a firm is called the ‘dissolution of the firm’ (Sec. 39). This means there is a difference between 'dissolution of partnership’ and ‘dissolution of partnership’.

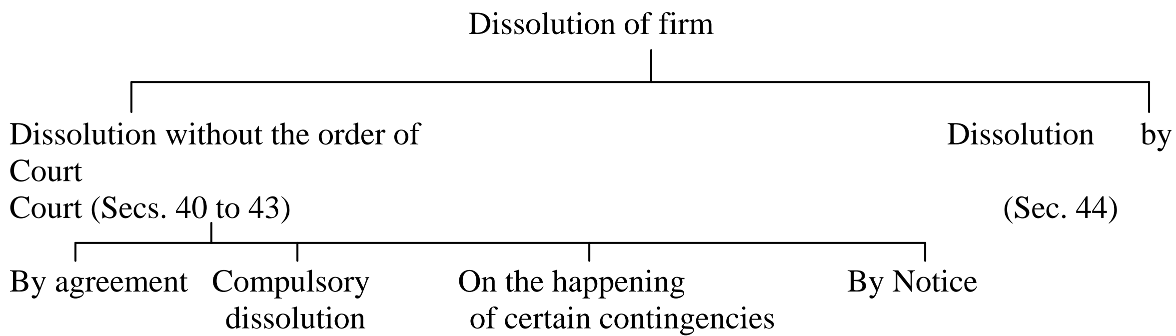
3.39.1 DISSOLUTION OF FIRM

It means complete breakdown or extinction of the relationship of partnership between all the partners of a firm. If this breakdown or severance of partnership relation is between a few and not all the partners (and the business is carried on), this amounts to dissolution of partnership and not of the firm.

3.39.2 DISSOLUTION OF PARTNERSHIP

It involves only a change in the relation of the partners. For example, if there is a partnership between A, B and C, and C retires, the partnership between A, B and C comes to end and partnership between A and B comes into being. The new firm with A and B as its partners is called 'reconstituted firm'. Thus retirement of a partner from a firm does not dissolve the firm. It merely severs the partnership relation between the retiring partner and the continuing partners. It leaves the partnership amongst the continuing partners unaffected and the firm continues with the changed constitution.

Dissolution of a firm may be voluntary or without the order of the Court, or it may take place by the order of the Court.



3.39.3 DISSOLUTION WITHOUT THE ORDER OF COURT

It may take place in one of the following ways:

1. Dissolution by agreement (Sec. 40):

   A firm may be dissolved –

(a) with the consent of all the partners, or

(b) in accordance with a contract between them.

The contract for the dissolution of the firm may be express or implied.

2. Compulsory dissolution (Sec. 41):

A firm is compulsorily dissolved-

(a) By the adjudication of all partners or all the partners but one as insolvent. The reason for this is simple. A partner on being adjudicated insolvent ceases to be a partner on the date on which the order of adjudication is made (Sec. 34 (1)]. If, therefore, all or all the partners but one are adjudicated insolvent, the firm can no longer exist, for there must be at least two partners to constitute a firm.

By the happening of any event which makes it unlawful for the business of the firm to be carried on, or for the partners to carry it on in partnership.

Example:

A, a resident in India, and B a resident in Pakistan, are partners. War breaks out between India and Pakistan. The partnership becomes unlawful and is dissolved automatically on the outbreak of war.

If the business of a partnership is unlawful from its very inception, such partnership is void and no question of its dissolution arises. If some out of the several businesses or adventures of a partnership become unlawful, the illegality of one or more of the

businesses or adventures will not of itself cause the dissolution of the firm in respect of its lawful businesses or adventures.

3. Dissolution on the happening of certain contingencies (Sec. 42):

Subject to contract between the partners, a firm is dissolved by-

i. the expiry of the term for which the firm was constituted,
ii. the completion of the particular adventure or adventures, if the firm is constituted for the execution thereof,
iii. the death of a partner, and
iv. the adjudication of a partner as an insolvent.

4. Dissolution by notice of partnership-at-will (Sec. 43):

Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm. (Sec. 43 (1)]. The firm, in such a case, is dissolved as from the date mentioned in the notice as the date of dissolution or, if no date is so mentioned, as from the date of the communication of the notice [Sec. 43 (2); Bodheshwar vs. Jatindar Nath. AI.R, (1976) Gau. 12]. The notice should be an unambiguous intimation of a final intention to dissolve the partnership, and should be served on all the other partners. Notice once given cannot be withdrawn unless all the other partners agree to it [Jones vs. Lloyd (l874) I.R 18 Eq. 265].

3.39.4 DISSOLUTION BY COURT

Under Sec. 44, the Court may, at the suit of a partner, dissolve a firm on the following grounds:

1. Insanity:

Where a partner has become of unsound mind, the Court may dissolve the firm on the petition of any of the other partners or by the next friend of the insane partner [Sec. 44 (a)].

2. Permanent incapacity:

Where a partner, other than the partner suing, has become in any way permanently incapable of performing his duties as a partner, the Court may dissolve the firm [Sec. 44 (b)]

3. Misconduct:

Where a partner, other than the partner suing, is guilty of misconduct and it is likely to affect prejudicially the carrying on of the business, regard being had to the nature of the business, the Court may dissolve the firm [Sec. 44 (c)].

The following cases have been held to be sufficient grounds for the dissolution of a firm:

i. Gambling by a partner on a stock exchange, though such gambling may in no way be connected with the business of the firm;
ii. Fraudulent breach of trust by a partner;
iii. Persistent refusal or neglect by a partner to attend to the business
iv. Taking away of partnership books by a partner.

4. Persistent breach of agreement:

Where a partner, other than the partner suing, wilfully or persistently commits breach of the partnership agreements relating to the management of the affairs of the firm or conduct of its business, or otherwise so conducts himself that it is reasonably practicable for the other partners to carry on the business the firm with him, the Court may, at the instance of any of the other partners, dissolve the firm [Sec. 44 (d)]. Thus if one of the partner keeps erroneous accounts and omits to enter receipts or if there is continued quarrelling between the partners or there is such a state of animosity that all mutual confidence is destroyed, the Court may order for the dissolution of the firm.

5. Transfer of interest:

Where a partner has in any way transferred the whole of his interest in the firm to a third party or where his share has been attached under a decree, or sold in the recovery of arrears of land revenue, the Court may dissolve the firm at the instance of any other partner [Sec. 44 (e)].

6. Business working at a loss:

Where the business of the firm cannot be carried on except at a loss, the Court may dissolve the firm at the suit of a partner [Sec. 44 (e)]. This clause gives discretion to the Court to dissolve a firm for a fixed term even though the term has not expired, if the business thereof cannot be carried on except at a loss. A partnership is formed essentially to earn and share profits of the partnership. If the business can be carried on only at a loss, the attainment of the common end, with a view to which the partnership was formed, becomes impossible. In such a case, the Court may dissolve the firm.

7. Any other ground:

The Court may dissolve a firm on any ground which renders it just and equitable that the firm should be dissolved [Sec. 44 (f)]. Lord Lindley has observed in this regard that "refusal to meet on matters of business, continued quarrelling, and such a state of animosity as precludes all reasonable hope of reconciliation and friendly co-operation, have been held sufficient to justify- a dissolution. It is not necessary in order to induce the Court to interfere, to show personal rudeness on the part of one partner to the other, or even any gross misconduct as a partner. All that is necessary is to satisfy the Court that it

is impossible for the partners to place that confidence in each other which each has a right to expect and that such impossibility has not been caused by the person seeking to take advantage of it."

Sec. 44 is not made subject to the contract between the partners and gives a right to a partner to seek the assistance of the Court to have a partnership dissolved on grounds specified in the Section [V. Venkataswami vs. G. Venkataswamy, AI.R. (1954) Mad. 9].

3.39.5 RIGHTS AND LIABILITIES OF PARTNERS ON DISSOLUTION

Rights of a partner on dissolution

On the dissolution of a partnership firm, a partner has the following rights, namely-

1. Right to have business wound up (Sec. 46):

On the dissolution of a firm every partner or his representative is entitled to have the property of the firm applied in payment of outside debts and liabilities of the firm, and have the surplus distributed among the partners or their representatives in accordance with their rights. This right of a partner is called "partner's lien".

2. Right to have the debts of the firm settled out of the property of the firm(Sec. 49):

Where a firm is dissolved, the debts of the firm are settled out of the property of the firm, and if there is any surplus it is utilised towards payment of the private debts of the partners. Similarly as regards the private debts of the partners, the private estate is first applied in payment of the private debts and if there is any surplus, and if there be a need, it is utilised towards the settlement of the debts of the firm.

3. Right to personal profits earned after dissolution (Sec. 50):

Where any partner has bought the goodwill of the firm on its dissolution, he has right to use the firm name and earn profit by its use.

4. Right to return of premium on premature dissolution (Sec. 51):

Where a partner has paid a premium on entering into partnership for a fixed term and the firm is dissolved before the expiration of the term, he is entitled to repayment of the whole or part of the premium, regard being had to-

i. the terms upon which he became a partner, and
ii. the length of the time during which he was a partner.

No refund can, however, be claimed where the dissolution

i. though prematurely is due to the death of a partner, or

ii. is mainly due to the misconduct of the partner who had paid the premium, or

iii. is in pursuance of an agreement which contains no provision for refund of the premium or any part thereof.

5. Right where partnership contract is rescinded for fraud or misrepresentation (Sec. 52):

Where a contract creating partnership is rescinded on the ground of fraud or misrepresentation of one of the partners, the partner entitled to rescind has the following rights, namely,

i. Right of lien on the surplus assets:

   He has a lien on the surplus assets after the debts of the firm have been paid, for any sum paid by him for the purchase of his share in the firm and for any capital contributed by him.

ii. Right of subrogation:

   He is subrogated to the rights of the partnership creditors in respect of any payment made by him towards the debts of the firm. This means if he pays off any creditor of the firm from his own pocket, he steps into the shoes of that creditor. i.e., he becomes the creditor of the firm for that amount.

iii. Right to be indemnified:

   He has also a right to be indemnified by the partner or partners guilty of fraud or misrepresentation against all the debts of the firm.

6. Right to restrain partners from use of firm name or property (Sec. 53):

After a firm is dissolved, every partner or his representative may restrain any other partner or his representative from carrying on similar business in the firm name or from using any of the property the firm for his own benefit, until the affairs of the firm have been completely wound up. This restriction does not apply

i. When there is contract between the partners to the contrary, or

ii. when a partner has bought goodwill of the firm.

Liabilities of a partner on dissolution:

1. Liability for acts of partners done after dissolution (Sec. 45):

In order to absolve partners of the liability for any act done after dissolution of the firm, a public notice must be given of the dissolution. If this is not done, the partners continue to be liable as such to third parties for any act done by any of them after the dissolution. Further in such a case the act of a partner done after the dissolution is deemed to be an act done before the dissolution.

Example:

A and B, partners in a trade, agree to dissolve the partnership. They execute a deed for that purpose declaring the partnership dissolved as from January 1, but do not discontinue the business of the firm or do not give a public notice of the dissolution. On February 1, A indorses a bill in the partnership name to C. The firm is liable on the bill.

The following, however, are not liable for the acts done after the dissolution of the firm, and no notice of dissolution need be given:

i. the estate of a deceased partner,

ii. the insolvent partner, and

iii. the sleeping or dormant partner who retires.

2. Continuing authority of partners for purposes of winding up (Sec. 47):

After the dissolution of a firm, the authority of each partner to bind the firm, and the other mutual rights and obligations of the partners continue, so far as may be necessary-

i. to wind up the affairs of the firm, and

ii. to complete transactions begun but unfinished, at the time of the dissolution.

The firm is not liable for the act of an insolvent partner in the above two cases. But, if a partner represents himself or knowingly permits himself to be represented as a partner of the insolvent partner, the firm is liable on the ground of 'holding out'.

Check your progress 39:

How are partnership firms dissolved?

Lesson end activities:

Go to a bank and learn about various types of negotiable instruments and their features.

Collect information on successful partnership business.

Let us sum up:

- The Negotiable Instruments Act, 1881 came into force on 1st March, 1881.
- Negotiable Instrument means a promissory note, bill of exchange or cheque, payable either to order or to the bearer.
- According to Section 4 of the Negotiable Instruments Act, 1881, "A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money only to the order of a certain person or to the bearer of the instrument."
- According to Section 5 of the Negotiable Instruments Act, 1881, "A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of a certain person or the bearer of the instrument." Thus, a bill is an order by a creditor upon his debtor requiring him to pay the money to the person specified.
- A cheque is a bill of exchange which is drawn upon a specified banker, and payable on demand.
- The process of transferring an instrument is called an endorsement
- Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all (Sec. 4, Para 1). Persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm' (Sec. 4, Para 2).
- A partnership is based on an agreement. The partnership agreement may be made orally or in writing or may be implied from the course of dealing among partners. However, all the essential elements of a 'valid contract' must be present.
- Persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm', and the name under which the business is carried on is called the 'firm name' [Sec. 4, Para 2].
- The registration of a firm may be effected at any time by filing an application in the form of a statement, giving the necessary information, with the Registrar of Firms of the area.

UNIT – IV

LESSON-40

CONTRACT AND PRINCIPLES OF INSURANCE

CONTENTS

4.40.1 Essentials of an insurance contract

4.40.2 Kinds of insurance contracts

Check your progress: 40

Lesson End Activities

AIMS AND OBJECTIVES

This unit will help the students to understand:

- The contracts of insurance
- The principles of the contract of insurance
- The major types of insurance and the various policies under each type
- The significance of insurance for business

INTRODUCTION

One should know the law to which he is subject because ignorance of law is no excuse. Insurance deals with the risks people face in their personal as well as business life. A good understanding of the contracts of insurance will help one to take enough care to secure their lives, the lives of their beloved ones and also the property which belong to them personally as well as in the course of their business transactions.

Generally, people are not ready to face risk and this makes them reluctant to take decisions in daily life. Risk is the basis of Insurance. In order to cover the losses arising due to uncertainties everyone wishes to insure his future activities. In this world of uncertainties, we daily come across different types of uncertainties such as fire, floods, death, accidents, theft, earthquake, storms etc. and losses arising out of such acts are of great volume and create a great discouragement and disappointment in this society. Hence, every common man has a fear for such acts which may occur at any time. So human history is a testimony to the fact that man always tried to cover his risks, which ultimately gave birth to the theory of insurance. Even in presence of uncertainty and risk, man has made all round progress almost in all fields because insurance gave the coverage against risks.

Benjamin Franklin observed that in this world nothing can be said to be certain, except death and taxes. Still there remains some amount of uncertainty even about these two phenomena: no one is sure when he is to die and what will be tax rates and rules in the coming period. As such, the whole world is surrounded by uncertainty and risks.

From the above we can see that risk and insurance are correlated with each other. Insurance technique cannot eliminate risks but it can minimise the financial loss caused by a particular risk. So, insurance is a contract under which the whole loss is spread over a large number of persons who are exposed to the loss caused by a particular risk. Hence, insurance is a contract under which insurance company agrees to pay a certain sum of money to compensate loss caused by the occurrence of uncertain event in consideration of certain periodical payment i.e. premium.

A contract of insurance is completed as soon as the insurance company accepts the premium after the proposal being accepted. Thus, it implies that the following essential elements are deemed to be fulfilled after the acceptance of the consideration i.e. premium by the insurer. The most important elements or fundamental principles must strictly be satisfied for a valid insurance contract.

4.40.1 ESSENTIALS OF AN INSURANCE CONTRACT

Following are the essentials of an Insurance Contract:

1. Written Agreement:
   Insurance is a written agreement between the insurer and the insured wherein the insured makes an offer and the insurer accepts his offer or in this filling up of a proposal form by the proposer is an offer and the notice of acceptance of the proposal form by the insurance company is an acceptance of insurance. So insurance agreement must be in writing.

2. Consideration:
   Insurance is a contract by which one party in a consideration called premium, takes over a particular risk of the other party and promises to pay to the insured or his nominee a certain sum on the happening or occurrence of an uncertain event. So in this when Insurance accepts the premium (i.e. consideration) automatically the particular risk is also taken over.

3. Competency:
   A proposer must be competent to enter into contract. If the insured person is of sound mind and has attained age of majority, he is said to be competent to enter into an agreement or contract. Also, he must not be debarred by any law, to which he is subject, to enter into agreement. Any insurance policy taken by a legal guardian on a minor’s life will constitute a valid contract.

4. Lawful Object:
   There must be a lawful object and that should not be illegal, immoral or against the interest of the public. Thus, the object of insurance must be lawful one.

5. Mutual Faith:
   There should be mutual faith between insured and insurer. Insured should disclose all the possibilities of losses in his proposal form. He should not misrepresent to the insurer. He should pay sincerely his premium in time and in turn, the insurer should pay the assured amount at the time of loss or maturity without causing any unnecessary hardship for the assured. So, the intention of both the parties should be clear because Insurance contract is based on the mutual faith of Insurer and Insured.

6. Certain:
   The agreement between the insured and the insurer should not be vague, loose and uncertain. The terms and conditions must be clearly understood by both. So, we can say that agreement between two must be certain. In insurance the terms and conditions are deemed to be understood as the proposer gives an understanding on the proposal form. On the other hand, the insurer also-issues a printed policy document which contains all the terms and conditions of insurance contract.

7. Possibility of Performance:
   In insurance, the agreement must be capable of being performed. A promise to do an impossible thing cannot be enforced. But in contract of insurance, there is every possibility of its performance. The insurance company must be able to pay the money on happening of the event and the insured is also expected to make regular payment of premium.

8. Contract of Subrogation:
   Contract of general insurance comes under the doctrine of subrogation because after the insured is compensated for the loss caused by the damage to the property insured by him, the right of ownership of such property passes on to the insurer. If the damaged property has any value left or the lost property is recovered that cannot be allowed to remain with the insured, because in that case he will realise more than the actual loss which is against the principle of indemnity.

9. Insurable Interest:
   No person can make or enter into a contract of insurance unless he has insurable interest in the subject matter to be insured. One can have an insurable interest only when one would be put to a financial loss by the happening of the event against which a thing or a life has been insured. In life insurance, the insured has an insurable interest in his own life as well as in the lives of other person by whose death he may be prejudiced financially. In the case of General insurance a person has an insurable interest in the property which is owned by him.

4.40.2 KINDS OF INSURANCE CONTRACT

1. CONTRACT OF INDEMNITY

The principle of indemnity also applies to all contracts of insurance except the contracts of life insurance where:

1. the loss suffered by the insured can be measured in money terms;
2. a mode of putting the insured after the mitigation of loss in the same position in which he was placed just before the occurrence of loss.

Hence all the contracts of insurance except life insurance are the contracts of indemnity. Indemnity means to make good the loss and nothing more than the actual loss. In accordance with the principle of indemnity, the insured's actual loss is indemnified on the occurrence of certain event. The basic objective of the insurance is, in fact, to transfer the loss of an individual over to the insurer who in turn very easily spreads it over a larger number of persons (insured). The compensation can never be more than the amount of actual loss suffered by the insured as such, the insured is never allowed to make profit out of loss. In other words, the maximum amount of compensation never exceeds the amount of actual loss or the value of policy, whichever is less.
For example, Mr. Deka gets a fire insurance policy of Rs. 1,00,000 for the goods lying in the factory premises. He suffers a loss due to fire which broke out in the factory to the tune of Rs. 1,50,000. The insurance company will indemnify Mr. Deka's loss only up to Rs. 1,00,000. Suppose the loss in the case is to the tune of Rs. 80,000. Then, the insured could have been compensated only up to Rs. 80,000. So if the insured is allowed to get more than the actual loss or amount of policy which is against the principle of indemnity, he will try to make a profit by destruction of his own insured property intentionally which is against the national interest and also against the public interest. By the result the whole world will try to do only anti social acts and everybody would be interested in gaining after destruction of his property after getting the over-valued insurance policy.

If the principle of indemnity is not applied in the case for smaller loss, large amount in form of compensation will be paid and by that insured will earn the profits out of loss and this will increase the cost of insurance and premium of insurance also.

Conditions:

For application of indemnity principle the following conditions should be fulfilled:

a. The insured has to give the proof that the loss is actual monetary loss for which he got the insurance policy.
b. Indemnification cannot be more than the value of the policy in any case.

c. After the compensation is paid to the insured if the damaged property has any value left or the lost property is recovered that cannot be allowed to remain with the insured.

d. This principle is not applicable to life insurance.

e. If insured receive some amount from third party and also from insurance company even then that amount cannot be more than the actual loss or value of policy whichever is lower.

2. LIFE INSURANCE CONTRACT

Life insurance is a contract in which insurer, in consideration of a premium, undertakes to pay a certain sum of money either on the death of the insured to his/her nominees or on the expiry of fixed period to him/her.

Suppose A gets the life insurance policy on 10 Jan. 1996 for 14 years for Rs. 1,00,000. If he dies before the expiry of policy then his claimant will get the claim and if he survives up to the expiry of policy then he himself will get the maturity value of the policy. So it is an important device to provide family security on voluntary basis through individual initiative. Life is full of uncertainties and death is certain. Insurance manages to stop the sufferings of financial losses caused by the death of the insured. It undertakes to protect the loss out of the death of the insured.

Life insurance involves both the elements of protection and investment. As in this case, if the insured lives up to the maturity the policy, the investment made by the insured in the form of periodical premium along with fixed bonus is paid back to the insured on the maturity of the policy. Otherwise the full amount of policy is paid to the nominee after the death of insured.

Check your progress: 40

What is contract of insurance?

Lesson End Activity:

Learn the functioning of insurance companies in your locality.

LESSON-41

FUNDAMENTAL PRINCIPLES OF INSURANCE

CONTENTS

4.41.1 Fundamental principles of insurance
Check your progress: 41
Lesson End Activities

Section 10 of the Indian Contract Act defines a contract as, "All agreements are contracts if they are made by the free consent of parties, competent to contract, for a lawful consideration and with a lawful object and are not hereby expressly declared to be void." As such, insurance is a 'contract' by which one party (Insurer) for a compensation (consideration) called the premium, takes risks of the other party (offerer or insured) and promises to pay to him or his nominee a certain sum of money on a specified contingency.

4.41.1 FUNDAMENTAL PRINCIPLES OF INSURANCE

A contract of insurance, in addition to fulfilling the basic or essential characteristics of a valid contract, i.e., proposal, acceptance, free consent, competency of the parties, also observes some of the fundamental principles of insurance, such as:

- Insurable interest
- Utmost good faith
- Indemnity
- Subrogation
- Contribution
- Proximate cause
- Mitigation of loss, etc.

Now we shall discuss in detail all of these basic principles of insurance.

1. PRINCIPLE OF INSURABLE INTEREST

A person can enter into a valid contract of insurance only if he an insurable interest in the object or in the life of the insured on. In case, the element of insurable interest is not present, as this principle requires, the insurance contract would be a wagering act which is

not valid and as such cannot be enforced in the court of law. As such, in the absence of insurable interest, no contract of insurance can come into existence. In other words, it would amount to be a void contract.

MEANING OF INSURABLE INTEREST

The principle of insurable interest is a precondition for a valid act of insurance. The person getting an insurance policy must have an insurable interest in the subject matter to be insured. A person is said to have an insurable interest in the property, if he is financially benefitted by its existence and is prejudiced by its loss, destruction or non-existence. Similarly, a person taking a life insurance policy must have an insurable interest in the life of the insured person. The insured must positively stand benefitted financially due to existence or continuance of life; preservation of the object insured or he must suffer a financial loss on the happening of an event against which he seeks insurance. For example, an employer has insurable interest in the lives of his employees, a banker has an insurable interest properties mortgaged to it against a loan. Similarly, a creditor has an insurable interest in the life of his debtor. As such the ownership of property or insuring oneself is not a necessary condition for establishing an insurable interest.

Section 7 of the Marine Insurance Act, 1963 lays down a statutory definition of the 'principles of insurable interest' as follows:

Sub-section 1: Subject to the provisions of the Act, every person has insurable interest who is interested in a marine adventure.

Sub-section 2: In particular, a person is interested in a marine adventure when he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property or may be prejudiced by its loss or by damage there to, or by the detention thereof, or may incur liability in respect thereof.

Prof. Hansall has defined insurable interest as a financial involvement.

IMPORTANCE OF INSURABLE INTEREST

The principle of insurable interest basically distinguishes insurance from gambling or wagering transactions. In case the insured has not an insurable interest in the property insured, the contract of insurance would amount to a gambling or speculative- contract. As such, no person can enter into a valid contract unless he has insurable interest in the subject matter of insurance. The most clear and common case of existence of pecuniary insurable interest is the ownership of the property being insured and insuring own life. Insurable interest may also exist due to the use, value or profit of the property such as mortgages, bailment, shipment, etc.

EXISTENCE OF INSURABLE INTEREST

The rules in regard to the existence or presence of insurable interest in respect of life, marine and fire insurance differ widely.

In case of life insurance, the person taking out a life policy must have a pecuniary insurable interest in the life of the insured person at the time of taking of the policy. It may or may not be present at the time of death of the person whose life is insured or at the time of making claim on maturity.

In case of fire insurance, insurable interest must exist both at the time of taking out the policy and also at the time when the loss occur and a claim is filed with the insurance company.

In case of marine and other insurances, insurable interest must be present at the time of occurrence of loss. In other words, the insured has to establish his insurable interest in the insured object at the time when claim of loss is made on the happening of certain or uncertain event insured against. However, it may not be present at the time of entering the contract.

Here it must be noted that in marine cargo insurance, insurable interest is required to exist at the time of loss only, but in marine insurance, insurable interest must be present both at the time of taking policy and at the time of loss. However, in case of marine cargo insurance the insured must have a genuine expectation of acquiring insurable interest.

An analysis of the definition given under Section 7(2) of the Marine Insurance Act, 1963 provides three essentials of insurable interest in respect to all types of insurances.

1. Subject matter of insurance must be certain. There must exist some property, rights, interest, life or potential liability, which must be capable of being insured, called the subject matter. It must be ascertainable.

2. The insured must bear a legal relationship to the subject matter or he must be the owner thereof. He stands to benefit by the safety or continuous existence of the property, rights, interest, life or liability and stands to lose by any loss, damage, injury, death or creation of liability to the subject matter.

3. The insured must be the owner or may possess the legal rights or interest in the subject matter to be insured. As such the ownership or legal rights or relationship of the insured person must exist in the property, rights or life or any potential liability.

In case the above three legal conditions are not present, the subject matter or life cannot become an insurable interest and hence is not capable of being insured. In other words, insurable interest is understood as an interest in the preservation, existence or continuance a thing or a life, as the case may be, recognised by law. Whosoever has an interest in the

subject matter may insure that thing or life. Such interest must be pecuniary or financial in nature. In a nutshell, it may be concluded that one can have an insurable interest only when one would stand to benefit financially by the existence or continuance of the subject or life insured and conversely one would be put in a financial loss by the happening of the event against which a thing or life of a person has been insured. Moreover, the interest must not be merely sentimental but pecuniary in nature and must be capable estimation in money terms.

INSURABLE INTEREST IN LIFE INSURANCE

The following persons may have an insurable interest in the subject matter under the life insurance.

1. A person has an unlimited insurable interest in his own life.
2. A husband in the life of his wife.
3. A wife in the life of her husband.
4. A father in the life of his son, if he is dependent on his son.
5. A son in the life of his father, if he is dependent on his father
6. A creditor in the life of a debtor to the extent of the amount of debt.
7. A partner in the life or lives of his co-partner or co- partners.
8. An employer in the lives of his employees or servants.
9. An employee employed for a specified period in the life his employer.
10. A sister in the life or lives of his brother(s).
11. A brother in the life or lives of his sister(s).
12. A mother in the life of her son(s).
13. A son in the life of his mother.
14. Insurance Company in the lives of insured for re-insurance purposes.
15. A guarantor in the life of his guarantee.
16. An agent in the life of his principal.
17. A principal in the life of his agent.

INSURABLE INTEREST IN FIRE INSURANCE

Fire insurance cannot be valid without the existence of genuine insurable interest in the subject matter to be insured. The following persons may have insurable interest in the subject matter under fire insurance:

1. The owner of the property has an insurable interest in property.
2. Every partner has an equitable insurable interest in properties of the firm.
3. Husband and wife have a joint insurable interest in their respective properties.
4. A creditor has an insurable interest in the property on which he has a lien for his debt.
5. An agent has an insurable interest in the property of his principal.
6. A bailee has insurable interest in the properties or articles bailed.
7. A trustee has insurable interest in the properties covered under trusteeship contracts.
8. An insurer has insurable interest in respect to all those risks covered under the re-insurance.
9. A mortgager has insurable interest in the full value of property so mortgaged.
10. A mortgagee has an insurable interest in respect of any sum likely to become due under the contract of mortgage.
11. A lessee has an insurable interest in the properties got on lease.
12. A contractor has insurable interest in the properties constructed on contract basis.

INSURABLE INTEREST IN MARINE INSURANCE

The following persons may have insurable interest in marine insurance:

1. The owner of the ship in the ship.
2. The cargo owner in his cargo.
3. The master and the crew of ship in their remunerations.
4. A creditor who has lent money on ship or cargo to the extent of the debt.
5. A mortgagor in the property so mortgaged.
6. A mortgagee to the extent of sum due to him under mortgage and interest thereon.
7. The ship owner in the freight to be received.
8. A trustee in the properties held under trust.
9. An insurer in the subject matter of re-insurance.

2. PRINCIPLE OF UTMOST GOOD FAITH

Basically, the contracts of insurance are contracts of *Ubereimae fidei*, means the contracts which require absolute and utmost good faith on the part of all the parties concerned with the contract. As such, insurance contracts are contracts of utmost good faith and absence of good faith may result in the invalidation of contracts of insurance.

MEANING

According to the provisions of Indian Contract Act, 1872 all commercial contracts require that good faith must be observed, otherwise these shall be null and void. By good faith, we mean absence of fraud or deceit on the part of the parties to the contract. But under the contract of insurance greater degree of good faith is expected from the insured, in respect to disclosed all the material facts relevant to the contract; it is, therefore, called utmost good faith.

As such, insurance contracts are different from ordinary business contracts which are based on the principle of 'Caveat emptor' (let the buyer beware) as seller has no duty to disclose any information about the subject matter of the contract to the buyer. The buyer is expected to take all reasonable care to satisfy himself as to the genuineness of the material facts disclosed or not disclosed and the buyer will have to bear all the risks of loss and have no remedy against the seller. But the contracts of insurance are fiduciary in nature and hence require utmost care or duty on the party of the proposer so as to disclose all material facts relevant to the contract. In fact, each one of the parties i.e. insurer and insured is under an obligation to disclose relevant material information which may affect the decision of each other party.

Material information is that information which enables the insurance company to decide:

1. whether to accept or not to accept any risk.
2. secondly, if accepted, at what rate of premium and on what terms and conditions.

The legal bindings applies particularly to the insured who is in possession of all material facts relating to the subject matter of insurance contract and the insurer does not have any knowledge about all these relevant facts. This legal binding applies not only to materials facts which the proposer knows or possesses, but is also extended to all other material facts which he ought to know or possess about the risk to be insured.

Section 19 of the Indian Marine Insurance Act, 1963 provides that:

A contract of marine insurance is a contract based upon the utmost good faith and if the utmost good faith is not observed by either party, the contract may be rescinded by the other party.

In other words, it is the legal duty of each party to disclose all the material facts which may have some effect on the decision of the other party. If at any time, it is found that the insured has concealed some material facts, the contract of insurance becomes voidable at the option of the insurer. Just in the same manner, the insurer must also disclose the scope of insurance under the clause of 'utmost good faith'.

Lord Mansfield has rightly pointed out in this regard that 'Insurance is a contract upon speculation. The special facts upon which the contingent chance is to be computed lie

most commonly in the knowledge of insurance only ... the risk understood and intended to be run at the time of agreement'.

The obligation of disclosing material facts ends when the contract insurance is concluded with the issuance of cover note or a policy and such obligation again arises at the time of renewal of policy. However, in some cases the insured is exempted from disclosing the following material facts and as such principle of utmost good faith does not apply:

1. Facts already known to the insurer.
2. Facts which reduce the risk one way or the other.
3. Facts which the insurer himself does not want to be disclosed.
4. Facts which every insurer is ought to know or possess.
5. Facts whose disclosure becomes unnecessary due to the presence of warranty in the contract.
6. Facts governing the terms and conditions of the policy.
7. Facts whose nature is such that they are commonly known to the public.
8. Facts which can be concluded or inferred from the information or facts already provided by the insured.

PRINCIPLE OF UTMOST GOOD FAITH IN LIFE SURANCE

Under the contract of life insurance the person for taking out a policy has to fill up a proposal form. The insured must furnish all material facts known to or possessed by him. Generally, a printed (questionnaire) is supplied to the insured to answer the questions contained in it by furnishing detailed information in respect of the owing material facts:

1. Name, address and occupation of the insured person.
2. Date of birth, age, height and weight etc.
3. Facts about life and habits.
4. Family history (especially with regard to the health of each member) of the proposer.
5. Information about the· health of the proposer.
6. Quantum and nature of income of the proposer.

The proposer has to declare that he has answered all questions truly and correctly and he agrees that the proposal and declaration shall be the basis of contract of life insurance. Any concealment, furnishing of inaccurate or incorrect information will lead the contract to become null and void.

The breach of obligation of disclosing material facts with utmost good faith may arise in the following cases:

1. Non-disclosure of material facts.
2. Intention of non-disclosure of material facts.
3. Non-disclosure of material facts by negligence.
4. Misrepresentation of material facts with fraudulent purposes.

In case the insurance policy is taken through an agent, the agent is also under an obligation to disclose material facts known or possessed by him and the material facts as furnished by the insured must also be disclosed to the insurer, otherwise the contract becomes voidable. The obligation of disclosing material facts also arises if, during the period of policy, there occurs any change in the risk, terms and conditions of the policy.

PRINCIPLE OF UTMOST GOOD FAITH IN MARINE INSURANCE

The contract of marine insurance is primarily based on the principle of utmost good faith. The obligation to disclose material facts lies in greater on the insured than on the insurer. The proposer is required to disclose full information about the subject matter of insurance. This is binding particularly on the insured party who is naturally in possession of all material facts relating to the property (ship and cargo). In case any party does not act in good faith, the other party may cancel the contract. Under the contract of marine insurance the insured must disclose the following material facts in the proposal form:

1. Method of packing i.e. whether in single gunny bag or in double gunny bags, whether in container or in special mode of packing etc.
2. Nature of the goods.
3. The particulars of the ship carrying the goods.
4. The port of shipment and destination along with route of journey.

Generally, the marine proposal form requires the following information to be furnished by the insureds:

1. Name of the shipper or client, insured.
2. Full description of goods to be insured.
3. Method and type of packing.
4. Voyage or mode of transit.
5. Cover required and conditions of insurance.
6. Name of Steamer.
7. Sum to be insured.
8. Past claims experience.

Section 20 of the Marine Insurance Act prescribes the cases when the insured or his agent is exempted from following facts, disclosing unless otherwise insurer is required to disclose. The following are some of the cases:

1. Facts which the insurer already knows.
2. Facts which the insurer is expected to know in the normal course of business.
3. Facts that may tend to reduce the risk.
4. Facts waived by the insurer.
5. Facts covered under the warranty or other terms and conditions of the policy.
6. Facts which could have been concluded from the information supplied by the insured.

The insurance company finds a better way to cancel the contract or dismiss the claim on account of non-disclosure of material facts and a consequent breach of utmost good faith. Similarly, the insured may also rescind the contract in case the insurer does not exercise good faith in disclosing the scope of insurance.

PRINCIPLE OF UTMOST GOOD FAITH IN FIRE INSURANCE

The principle of utmost good faith also applies to the contracts of fire insurance on the part of both the parties i.e. the insured and the insurer. This legal binding applies particularly to the proposer who is in possession of all material facts relating to the subject matter to be insured. In case some alteration or material facts require substitution, the same must also be disclosed as soon as possible by the proposer. Non-disclosure or concealment of material facts will lead to the contract to become voidable at the option of the insurer. The insurer must also disclose facts of the policy to the proposer.

Hence the observance of utmost good faith is necessary on the part of both the parties. The obligation applies not only to the material facts which the parties know or possess, but also extends to material facts which they ought to know or possess and require disclosure. The following material facts are required to be disclosed under the contract of fire insurance:

1. Construction and description of building.
2. Situation of the building.
3. Particulars of occupier, whether office, residence, shop, godown, manufacturing unit, service undertakings, etc.
4. Nature of the goods or material i.e. normal, hazardous, non-hazardous, extra-hazardous, etc.
5. Particulars of previous losses suffered.
6. Previously lodged claims and their settlements, etc.

However, the proposer is not bound to disclose some material facts to the insurer (please see exemptions discussed under life or marine insurance under the previous points).

3. PRINCIPLE OF INDEMNITY

The principle of indemnity also applies to all contracts of insurance except the contracts of life insurance where:

1. the loss suffered by the insured can be measured in money terms;
2. a mode of putting the insured after the mitigation of loss in the same position in which he was placed just before the occurrence of loss.

Hence all the contracts of insurance except life insurance are the contracts of indemnity. Indemnity means “to make good the loss” and nothing more than the actual loss. In accordance with the principle of indemnity, the insured’s actual loss is indemnified on the occurrence of certain event. The basic objective of the insurance is, in fact, to transfer the loss of an individual over to the insurer who in turn very easily spreads it over a larger number of persons (insured). The compensation can never be more than the amount of actual loss suffered by the insured as such, the insured is never allowed to make profit out of loss. In other words, the maximum amount of compensation can never exceed the amount of actual loss or the value of policy, whichever is less. For example, Mr. X gets a fire insurance policy of Rs. 1 lakh for the goods lying in the factory premises. He suffers a loss due to fire which broke out in the factory to the tune of Rs.1,50,000. The insurance company will indemnify Mr. X’s loss up to 1 lakh. Suppose the loss in the case is to the tune of Rs. 80,000, the insured could have been compensated only up to Rs. 80,000.

Suppose, in the above case, the insurer agrees to pay a higher than the amount of actual loss or value of policy, this will be a constant temptation for insured to destroy the property intentionally, which is against the national interest.

Even the Common Law has introduced the principle of indemnity which helps one to distinguish easily a contract of speculation and contract of insurance.

PRINCIPLE OF INDEMNITY AND LIFE INSURANCE

The principle of indemnity does not apply to life insurance contract and other personal insurance because loss of individual’s life cannot be measured in money terms. In other words, the contracts of life insurance are not based on the principle of compensation in money terms. As such under the contracts of life insurance a fixed sum is agreed to be paid either on the expiry of a certain period or on the death of the insured. These are, therefore, called ‘contingent tracts’.

PRINCIPLE OF INDEMNITY AND FIRE INSURANCE

Basically, fire insurance contract is a contract of indemnity whereby the insured cannot claim anything more than the value of goods lost or damaged by fire or the amount of the policy, whichever is less. Generally, the amount of indemnity or compensation is the market value of the property at the time and as on the date of loss or damage property by fire. The principle of indemnity does not apply to valued policy which the insurer agrees to pay a predetermined amount in case the subject matter is damaged or destroyed by fire. The principle of indemnity lays down that:

The insured can be indemnified only up to the extent of actual loss.
The sum of indemnity can never exceed the value of the policy taken out.
In case of under insurance the loss is indemnified proportionately in the following manner:

$$\text{Amount of indemnity} = \text{Actual loss} \times \frac{\text{Value of the policy}}{\text{Value of the subject matter}}$$

PRINCIPLE OF INDEMNITY AND MARINE INSURANCE

Marine insurance is an arrangement by which the insurance company undertakes to indemnify the owner of ship or cargo against risks to which the ship or the cargo is exposed such as acts of storm, fire, sinking etc. The principle of indemnity prescribes that the insured shall be indemnified only to the extent of actual loss sustained by him. In fact, in the case of marine insurance, there is slight departure from the principle of pure or complete indemnity as the insurer agrees to indemnify the insured in cash and not by replacing the cargo or the ship. The amount of indemnity is, usually, decided at the time of taking out the policy and in some cases at the time of loss. There are two exemptions to the principle of indemnity in marine insurance:

1. Certain profit margin is allowed to be included in the value of cargo on the assumption that the insured may earn such profit when the goods reach their destination.

2. The Marine Insurance Act, 1983 allows the application of the doctrine of indemnity 'in the manner and to the extent agreed'. As such the value of indemnity is decided at the time of taking out the policy i.e. valued policies or agreed value policies under which the value of the policy is decided irrespective of the consideration of depreciation and other relevant factors.

PRINCIPLE OF INDEMNITY AND OTHER INSURANCES

The insurances of property, liabilities, fidelity and other risks are contracts of pure or complete indemnity. In all these types of insurances, the insured is indemnified in accordance with the principle of indemnity like in fire insurance contracts.

MAIN FEATURES OF PRINCIPLE OF INDEMNITY

On the basis of above discussion, one can easily draw certain salient features of the principle of indemnity. A few are described below:

1. All contracts of insurance, except the life insurance and personal accident insurance, are contracts of indemnity. As such this principle applies to all the contracts of insurance except the life insurance because the compensation payable and loss caused can be easily measured in money terms.
2. There exists indirect relationship between the principle of indemnity and principle of insurable interest because the insured has to prove the amount of actual loss and his interest therein in order to get compensation.
3. The amount of compensation (indemnity) shall never exceed the amount of actual loss or the value of the policy. But the marine insurance is not a pure indemnity contract.
4. After the settlement and payment of claim of compensation, the doctrine of subrogation applies i.e. the insured cannot hold the ownership rights and receive or claim the amount of compensation from any other party. In fact, the principle of subrogation is an extension of the principle of indemnity.
5. Valued policies (except marine policies) are not covered under the scope of principle of indemnity.

METHODS OF INDEMNITY

There are four alternative methods to indemnify an insured in the t of loss, damage or destruction of the subject matter insured. These are being described here as below :

i. CASH PAYMENT

Cash payment in the claim of insurance is the easiest and a very common method of indemnification. The insurer, after receiving the claim form, making of proper enquiries and receipt of surveyor's report or the loss-assessor's report, on its satisfaction with respect to the genuineness of the causes and amount of claim, evaluate the amount of actual loss to be compensated or indemnified. As such after the settlement of claim, the insurer makes the cash payment by cheque to the insured.

ii. REPAIRS

In some cases, the subject matter may have been partially damaged or not fully destroyed and capable of being repaired. In such cases the insurer instead of making cash payment prefers to settle claim of the loss or damage, by means of getting it repaired. The insured is to submit a detailed estimate of the cost of repairs whereby the insurer arranges an inspection of the damaged subject matter so as to determine the necessity and

reasonability of repairs and their cost. The insured is authorised to get it repaired and after that insured has to submit bill of repairs along with the note of satisfaction and then the repairer is paid. Indemnifying the insured by the method of repairs of subject matter is usually used in motor vehicle insurance, machine and building insurances.

iii. REPLACEMENT

In case the subject matter of the insurance policy is damaged, lost or destroyed to such an extent that it is not possible and feasible to get it repaired, the insurer may arrange the replacement of the subject matter. This practice is generally followed in case of theft or burglary insurances.

iv. REINSTATEMENT

Reinstatement is a method, rarely used, whereby subject matter destroyed is placed in its former position or condition as it existed just before the damage or loss. This method is generally used in respect of building or other properties damaged or destroyed by fire. It is applied only when the insured claims in excess than the cost of reinstatement and the insurer suspects of foul play or fraud which is proved. This method once selected cannot be substituted subsequently by the insurer.

The insurer only reserves the right to choose the method of indemnification and the insured has no right to choose the method of indemnification. But in case the method of reinstatement is chosen, it cannot be withdrawn or substituted by other method even by the insurer.

4. PRINCIPLE OF SUBROGATION

The principle of subrogation, also known as ‘Doctrine of Rights Substitution’ is, in fact, an extension and outcome of the principle of indemnity. Subrogation is the transfer of rights and remedies of the insured in the subject matter to the insurer after the indemnification. In other words, the insurer steps into the shoes of the insured and becomes entitled to all rights of action against the third party to recover the loss from the person responsible regarding the subject matter of insurance after the claim of the insured has been fully settled and paid. There exists always a possibility of getting something in addition to the claim received from the insurer by the insured e.g. value of scrap, damages from the person responsible for the loss and from several other alternatives.

The amount so received by the insured shall belong to the insurer and the insured shall hold that recovery as trustee for the benefit of insurer to the extent that the insurer is entitled to.

DEFINITION OF SUBROGATION

The Federation of Insurance Institutes had defined it as:

Subrogation is the 'Transfer of rights and remedies of the insured to the insurer who has indemnified the insured in respect of the loss.'

Dinsdale has defined it as:

"Subrogation may be defined as the insurer's right to receive the benefits of all rights of the assured against third parties which, if satisfied, will extinguish or diminish the ultimate loss sustained."

This principle has also been defined as the 'Doctrine of Rights Substitution' which means that the insurer steps into the shoes of the insured after settling the claim or after compensating the loss. The right of ownership of affected property passes on to the insurer.

NEED OF SUBROGATION

The principle of subrogation has been introduced with the purpose of safeguarding the interests of the insurers. If it had not been in operation, the insured might be enabled to collect more money than actual loss and as such, making profit and the wrong doers might have escaped their liability. Whenever the act is against the rule subrogation, it amounts to be against the public policy. Therefore, the common law requires the principles of subrogation to be applied to all contracts of indemnity.

The principle of subrogation can be explained with the help certain examples discussed below:

1. Under the common law, if the insured subject matter is destroyed due to the negligent acts of third party, the insured person shall be entitled to be indemnified by the third party. But under the principle of subrogation, the insurer, after indemnifying the insured, shall be entitled to get the insured's right of indemnification against the third party.
2. Under fidelity guarantee insurance, insurer becomes entitled to claim reimbursement from the defaulter but after indemnifying the insured.
3. Similarly, under marine policy, if cargo is destroyed or damaged due to the negligence of a carrier, then under the provisions of common law, the shipper or carrier is held liable to compensate the owner of cargo. But under the doctrine of subrogation, the insurer steps into the shoes of the insured for securing benefits arising out of the obligations of the carrier as determined under the common law.

4. A most common example is, when a car of the insured is damaged due to negligent driving of the driver of other vehicle. In such cases, under the doctrine of subrogation, the insured's right of recovery against the defaulter is passed on to insurer who has indemnified the loss under the contract of insurance.

As such, it is obvious from the illustrations explained above that the doctrine of subrogation applies to the acts of torts, salvage other acts of common liability capable of being insisted under the common law equitably.

The doctrine of subrogation is applicable to all contracts of indemnity even without the existence of express condition in the contract of insurance. However, it is clear that the doctrine of subrogation arises only after the settlement of claim of the policy. But in the case of fire and accident policies, subject to the inclusion of an express condition in this regard, the doctrine of subrogation may be applied even before the payment of claim because sometimes it becomes necessary to follow an action against the defaulter in order to ensure that the legal rights against the third party do not lapse by any delay.

IMPORTANT FEATURES OF PRINCIPLE OF SUBROGATION

1. Doctrine of subrogation is an extension and an outcome of the principle of indemnity and is applicable to all contracts of indemnity, except life insurance.
2. The common law of subrogation as applied to all contracts of indemnity arises only after the payment of claim is made to the insured by the insurer.
3. The rights of subrogation may arise even before indemnification of the insured except in case of marine insurance policies.
4. The insured is required to provide all necessary assistance to the insurer while enforcing the rights of subrogation against the defaulter party.
5. Under the principle of subrogation, the insurer is granted the right to sue the third party (defaulter) in his (insured's) name but the expenses of litigation are to be borne by the insurer.
6. If the insured gets any money on account of compensation from a third party, after being indemnified by the insurer, he shall hold the amount of such compensation as a trustee for the insurer.
7. The right of subrogation arises from the acts of torts, contracts and salvage, etc.
8. The principle of subrogation is automatically applied even without any express condition in the contract in this respect, i.e., it is an implied condition.
9. Under the principle of subrogation the insurer cannot recover anything more than the amount of indemnification paid to the insured, from the defaulter party. As such, the right of recovery is limited to the amount of claim paid.

5. PRINCIPLE OF CONTRIBUTION

MEANING AND DEFINITION OF CONTRIBUTION

Principle of Contribution is just another outcome of the doctrine of indemnity. The principle is also applied to all contracts of indemnity i.e. all contracts of insurance except the life insurance and personal accident insurance. Sometimes a person gets a subject matter insured with more than one insurer called the 'Double Insurance' whereby in the event of damage, he cannot claim anything more than the total loss from all the insurers together. Under the principle of indemnity, the insured cannot be restored to a better position than before the loss. In such cases the total loss suffered by the insured is contributed by different insurers in the ratio of the value of policies issued by them for the same subject matter.

The Federation of Insurance Institute, Bombay has defined the principle of contribution as:

"Contribution may be defined as the right of an insurer who has paid a loss under a policy to cover a proportionate amount from other insurers who are liable for the loss."

A more precise definition as given below can well explain the meaning of contribution.

"Contribution is the right of an insurer, who has paid under a policy, to call upon other insurers or otherwise liable for the same loss to contribute the payment. This doctrine ensures equitable distribution of losses between different insurers".

6. CAUSA PROXIMA (OR) PRINCIPLE OF PROXIMATE CAUSE

The principles of proximate cause or causa proxima are interchangeably used in insurance. The term causa proxima is a latin phrase which means nearest or proximate or immediate cause. It is helpful in deciding the actual cause of loss when a number of causes have contributed to the occurrence of loss. The maxim used in this regard is *Sed cause proxima non remote spectatur* which mean the near, or the direct and not the remote cause is to be looked for or taken into consideration for the purposes of indemnification. In other words, while determining the liability of the insurer, the nearest or proximate cause and not the remote cause of the loss is to be taken into account.

The doctrine of *causa proxima* is especially applicable to marine insurance.

Section 55 of the Marine Insurance Act, 1963 prescribes that the insurance company shall be liable to indemnify only those losses which have been caused by proximate or nearest cause covered under the policy and not for other remote causes. The section further

prescribes that the insurer must follow the doctrine of *causa proxima* for the purposes of determining the liability of the Insurer in the event of occurrence of loss.

Sometimes, under marine insurance, the loss or damages to the ship or cargo results on account of various causes and the loss so occurred may not be attributed to any single reason or cause. Marine insurance policies generally cover a large variety of risks including sinking, burning of cargo or ship while standing or moving, collision of ships, jettison, barratry, piracy and explosion etc. These may occur in a sequence or in a broken chain. The principle of proximate cause, in such cases, helps in determining the nearest cause of the loss or single out a cause which set in motion the occurrence of chain of events causing the loss. In case causing of the loss is insured then, the insurer shall be held to indemnify the loss.

Section 55(2) of the Marine Insurance Act, 1963 prescribes that an insurer shall be liable to indemnify the insured if the causes of losses are insured.

7. PRINCIPLE OF MITIGATION OF LOSS

Mitigation of loss means to minimise or decrease the severity of loss. Under this doctrine it is prescribed that whenever the insured event occurs, it shall be the duty of the insured to take all such steps to minimise the loss as would have been taken by any person who is not insured. As such, it is the duty of the insured to act to minimise the loss. In the event of loss, the logic behind the principle of 'mitigation of loss' is that the insured should not become careless and passive at the time of loss simply because his property is insured. Therefore, he must act like any uninsured prudent person. Now the question arises as to how an uninsured prudent person is expected to act in such conditions.

It is quite clear that the insured, as a prudent man, should risk his own life to save property which is getting damaged or destroyed in order to minimise the loss. All that is expected is that he must act reasonably, in the event of loss, to make the loss minimum as far as possible.

As such, the principle of mitigation of loss provides only a check on the behaviour at the time of loss. The principle of mitigation of loss should not be limited to the time of occurrence of loss but it must be extended even to the validity period of the policy. After insuring the subject matter with the insurer, the insured tends to become careless and negligent; that is why, every insurer, in consideration of agreeing to indemnify the loss, expects a genuine behaviour during the period of the policy, especially at the time of occurrence of loss.

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What are the fundamental principles of insurance contracts?

Lesson End Activities:

Meet insurance company officials and agents and discuss the fundamental principles of insurance and their applications.

LESSON-42

LIFE INSURANCE

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4.42.1 HISTORY OF LIFE INSURANCE

The accurate account of the history of life insurance is very difficult to give but from the various references, whatever is available that shows the presence of some type of protection nearly similar to modern day insurance since ages. In this context Manu and Yajnavalkya, the Hindu scripture are credited with insurance thoughts. In Rigveda, the Sanskrit word 'Yogakshema' found in Manav Dharma shows communal insurance. Greek and Syrian writers also mentioned about ancient form of insurance. Getting insurance against death was considered as an act against God.

In England, the concept of insurance emerged in 16th century. Richard Mortin issued the first policy on William Gybbon's life in the year 1536. W.Gybbon's policy gave great publicity to Life Insurance. The business was taken up by Private insurers and business used to get settled by gathering in Exchange Alley. Later, companies by the names 'Hand in Hand Society' and 'The Mercer's Company' came into existence in the year 1696 and 1698 respectively. The Society of Assurance for Widows and Orphans was started by Stainsfie1d in 1699. In 1719 the business of life insurance was undertaken in Joint Stock form. Then in 1721 Parliament passed an act which allowed the promotion of companies

with the object of Life Insurance business. So many big companies came up in Britain like The Royal Exchagne Assurance, London Assurance, British Insurance Company etc.

In Europe, there was a slow pace of development in this sector. In France, life insurance was prohibited till 19th century. In Germany, the first company in life insurance business came up in 1806 but closed down its operations due to internal wars. In USA, the first public insurance office was established in Philadelphia in 1721. But the rate of growth was very slow in USA because of wide fluctuations in death rates.

4.42.2 LIFE INSURANCE SCENARIO IN INDIA

In India, the historical beginning of insurance is not exactly known. The ancient Indian writers like Manu, Yajnavalkya mentioned about ancient forms of insurance. But the modern concept of insurance came into existence with East India Company in 18th century. So many insurance companies from Britain started coming to India to insure the English residents. They used to charge very high rate of premium due to high mortality rate in India. But in 19th century, when Indians were recruited to jobs in various offices, then they started seeking protection with insurance companies.

The first foreign company which started the business of insurance in India was 'Oriental Company' in the year 1818. It liquidated very early and again reappeared as the 'New Oriental'. In 1823 a Company named 'Bombay Life' started giving insurance policies for two-three year terms. Then 'Madras Equitable Company' came into existence in 1829. These companies failed due to improper and wrong policies with regard to valuation, management and depreciation norms etc. After that so many developments took place. Many European companies tried to establish business in India but failed to survive due to unethical business practices. The British Parliament passed an Insurance Act in 1870 and then a few organised efforts were made in the Life Insurance sector in India.

The First World War gave a boost to Indian business of Life Insurance. So many companies were formed to do the business of insurance. The period between First and Second World wars was very bad and depressing for the economy. The Industrialists started their own insurance companies. A single comprehensive legislation was passed on insurance by government for the first time in 1928. During the Second World War, so many new insurance companies came up. But they resorted to heavy speculation and serious financial irregularities were seen in them. Industrialists started banks and insurance companies and inter locked the investment. The Government passed the act in 1950 to stop interlocking.

The government took many constructive steps to regulate the business of Life Insurance and ultimately nationalised the business of Life Insurance in 1956. Life Insurance business was carried on by the only Company in India that was Life Insurance Corporation (LIC) of India. But now again government permitted the private sector to enter in this field.

A number of Private Sector Companies entered into life insurance business in India. Mostly Indian Companies entered into a joint venture with foreign companies to do jointly the business of life insurance. Some of them are HDFC - Standard Life Insurance Co. Ltd., Max-New York Life Insurance Co. Ltd., ICICI Prudential Life Insurance Co. Ltd., Om Kotak Mohindra Life Insurance Co. Ltd., SBI Life Insurance Co. Ltd., ING - vysya Life Insurance Co. (Pvt.) Ltd. Bajaj Allianz Life Insurance Co. Ltd. and the Metlife India Insurance Co. (Pvt.) Ltd. These Companies got registered with Insurance Regulatory and Development Authority (IRDA). Out of these, few companies have started marketing products in the life insurance sector.

The insurance business is presently estimated to be roughly Rs. 400 billion per year and is growing at the rate of over 20 percent per annum, ignoring the relatively underdeveloped sectors of health insurance, pensions and annuities. The life fund of LIC is currently more than Rs. 100,000 crore. The entry of private players is expected

to tap the underdeveloped market. In fact, the potential for growth and spread of life insurance is high in India due to higher economic growth, rapid ageing of population and a weak social security pension system. In India, a vast majority of workers have no old age income security. Private foreign players are expected to bring funds, technology and good management practices. India, being an under-developed country, its regulatory concerns are highlighted. In the initial phase, the insurance regulator, Insurance Regulatory a Development Authority (IRDA), would have to be concerned more with entry guidelines and capital requirements than with the regulatory details of market supervision".

Life insurance is a contract for payment of a sum of money to the person assured or failing him/her, to the person entitled to receive the same, on the happening of the event insured against. The contract of life insurance provides for the payment of an amount on the date of maturity or at specified dates at periodic intervals or at unfortunate death, if it occurs earlier. The contract also provides for the payment of premium periodically to the corporation by the assured. Life insurance is universally acknowledged to be an institution which eliminates 'risk', substitute certainty for uncertainty and comes to the timely aid to the family in the unfortunate event of the death of the bread-winner.

Life Insurance is a contract which seeks to reduce the financial uncertainties arising from the natural contingencies like old age and death. The fundamental function of life insurance is to protect the insured against the financial needs which may arise due to the death, disability or old age. It deals with financial implications on the death of a person or temporary loss of earnings during sickness. It is a contract between the insured and insurer to pay lump sum money insured or his claimant as the case may be against a consideration called premium. Every plan of insurance is simply a method of spreading financial loss over a large number of persons. Insurance institution eliminates risks and substitutes certainty for uncertainty. Life Insurance is sometimes called "Income replacement insurance', because it provides necessary support to the family of insured if death cuts off the income of the family due to the death of the bread-earner.

Life insurance is a contract in which insurer in consideration of premium undertakes to pay a certain sum of money either on the death of the insured to his/her nominees or on the expiry of fixed period to him/her. It is an important device to provide family security on voluntary basis through individual initiative. Life is full of uncertainties and death is certain. Insurance manages to stop the suffering of financial losses caused by the death of insured. It undertakes to protect the loss out of the death of the insured.

Life Insurance involves both the elements of protection and investment as in this case if the insured survived up to the maturity the policy, the investment made by the insured in the form of periodical premium along with interest and bonus is paid back to the insured on the maturity of the policy, otherwise the full amount of policy is paid to the nominee in case of death of Insured.

4.42.3 DEFINITION OF LIFE INSURANCE

According to Insurance Act, 1938; under Section 2 (ii) of Life Insurance (Amendment) Act, 1950, “Life Insurance is the business of effecting contracts of insurance upon human life including any contract whereby the payment of money is assured on death except death by accident on the happening of any contingency dependent on human life and any contract which is subject to the payment of premium for a term dependent on human life.”

According to Bunyon’s law of Life Insurance, “A contract of life Assurance is that in which one party agrees to pay given sum on the happening of a particular event contingent upon the duration of human life in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another.”

According to J.H. Magee, “The Life Insurance contract embodies an agreement in which broadly stated, the insurer undertakes to pay a stipulated sum upon the death of insured or at some designated time to a designated beneficiary."

Thus, on the basis of the above definitions it may be concluded that life insurance is a contract by which insurer, in consideration of premium undertakes to pay a certain sum of money to insured or on the death of the insured to his nominee, whichever is earlier.

4.42.4 ECONOMIC BASIS OF INSURANCE

On the basis of present-day economic environment, there are few basic needs for which life insurance is needed. The life insurance is concerned with the hazards that stand across the life of every person, that is dying prematurely leaving dependent and that of living to old age without visible means of support.

a. Family Protection:
To protect the families from the economic hardships after the death of the bread-winner member of the family.

b. Investment of Savings:
Savings provide a new source of income when permanent earning stops and Life Assurance provide an immediate source of income for one’s family on the death of an insured person prematurely.

c. Additional way of Earnings:
It provides an insured additional earning by way of bonus and interest credited by the Insurance Company/Insurer.

d. Helpful at the Time of Cessation of Earnings:
Life assurance is needed because when one cease to earn money, insurer provides certain sum of money to the insured as per various terms of policies.

So the fundamental principle of life insurance is to save a person from uncertainties like premature death, old age etc.

4.42.5 CHARACTERISTICS OF LIFE INSURANCE

1. Like other contracts of insurance, the life insurance contract is also the outcome of an offer made by the insured and its acceptance by the insurer. Usually, contract of life insurance is made in writing.
2. The insurance company agrees to pay a certain sum of money either on the death of the insured or on the maturity of the policy, whichever is earlier.
3. The insured is under an obligation to pay periodically the amount of payment in form of Premium till the death of insured or expiry of the period of policy, whichever is earlier.
4. The contract of life insurance is not a contract of indemnity because the loss caused by the death cannot be calculated in money terms, nor money is a compensation for loss of one’s life.
5. Insurable interest must be present in the person insured at the time when the policy is taken in case of life insurance, which may or may not be present at the time of insured’s death.
6. Life insurance extends the hand of protection to those who are left without support and helps financially in case of death of the insured. It is also considered to be the best alternative for making savings.

7. Life insurance covers certain other risks which are connected with the human life in addition to the risk of death. For example, in case of total and permanent disability or temporary disability and medical expenses, compulsory retirement or the economic death risks, etc. have also been covered under the purview of life insurance these days.

8. It relieves the insured from the sword of democles i.e., various risks and uncertainties which may occur before and after the death of the insured.

4.42.6 ADVANTAGES OF LIFE INSURANCE

The following are the advantages of Life Insurance:

1. Superior Saving Plan:
   This is considered to be the best saving plan in comparison to other plans because it guarantees full protection against risk of death of the Insured. In life insurance, on death of insured, the full sum assured is payable with bonus wherever applicable whereas in other savings schemes, only the amount saved with interest is payable. No other saving plan provides this kind of protection.

2. Encourage Saving Habits:
   Life Insurance encourages saving habits. Long term savings can be made in a painless manner because of the easy instalment facility built in to the scheme. The insured person can pay premiums through monthly, quarterly, half-yearly yearly instalments. The salary saving scheme, popularly known as SSS provides a convenient method of paying premium each month through deduction from one's salary. The employer is authorised by the employee to deduct the insurance premium monthly and remit to the life insurance corporation and other Insurance Companies. The Salary Savings Scheme (SSS) can be introduced in any institution or organisation subject to specified terms and conditions laid down by insurer.

3. Suitable for Raising Loans:
   Life Insurance policy can be given as security to raise a loan even for commercial purposes also. The loan can be raised without any delay on safe security of the policy. Even after an initial period payment, if the policy holder finds it difficult to continue with the payment of premium, he can surrender the policy for a surrender value amount with the Life Insurance Corporation and other Insurers.

4. Protection against Creditors:
   The maturity value of Life Insurance policy can be protected against the claims of the creditors of the life assured by valid assignment of a policy. The policy holder can nominate a person to whom the policy money would be payable in the event of his death.

5. Tax Relief:
   Income-Tax relief is available for amounts paid by way of premium for life insurance subject to the income tax rates in force. Assessees can avail themselves of provisions in the law for tax-relief. In this manner, the assured is required to pay lower premium for his insurance than he would have to pay otherwise.

6. Estate Duty:
   Life Insurance ensures the definite sum of money after the death of the insured without resorting to sale of assets at a loss on realisation. So it is the best way of making provision for' payment of Estate Duty.

7. Economic Protection:
   Life Insurance provides economic protection to the family members of the insured in case of his untimely death who might be the sole bread-earner of the family. It reduces the sufferings of the families on happening of a contingent event. It is considered to be the most effective devise for providing family security.

8. Investment Element:
   In Life Insurance, the insured is required to pay the premium. The premium is a kind of investment. This premium is returned to the insured along with additional bonus amount after the expiry of the period of contract or date of death ever is earlier.

9. Helpful to the Government:
   Life insurance provides long term funds to the government for different development schemes. This helps the government to develop infrastructure and serve the society.

10. Money when needed:
    A suitable insurance plan or a combination of different plans can be taken out as life insurance to the specific needs that are likely to arise in future, such as children's education, start-in-life or marriage provision etc. Alternatively, policy money can be so arranged to be made available at the time of one's retirement from service to be used for any specific purpose, such as for the purchase of plot, house or for other investments. Loans are also granted to the policy holders, subject to certain conditions, for house building or for purchase of flats etc.

LIFE INSURANCE CONTRACT

Life insurance is a contract between insurer and the insured. In this contract the insurer in consideration of a premium undertakes to pay a certain sum of money either on the death of the insured or on expiry of certain period, whichever is earlier.

4.42.7 FEATURES OF LIFE INSURANCE CONTRACT

i. Nature of General Contract:
All the provisions of a general contract as provided in section 10 of the Indian Contract Act are applicable to insurance contract. The policy of life insurance is the evidence of legal contract and is subject to the provision of the Contract. According to Bunyon's law of Life Assurance, "A contract of Life Assurance is that in which one party agrees to pay a given sum on the happening of a particular event contingent upon the duration of human life in connection of the immediate payment of a similar or certain equivalent periodical payment by another."

The contract starts with a proposal (offer) and it is either accepted or rejected by the person to whom it is addressed. If it is accepted, it becomes a contract. The agreement becomes a contract only when other conditions like free consent, valid consideration, competency of parties, lawful object etc. are present in the agreement. When the proposer or acceptor fails to fulfil his part of obligation, the other party may seek remedial action through the court. The court orders the remedy in the public interest. The essentials of a valid contra are as follows:

a. Offer and Acceptance:
In a Life Insurance Contract offer is given by the insured and accepted by the insurer. Offer or proposal is defined as, "when one person signifies to another his willingness do or to abstain from doing anything with a view to obtaining assent to that other to such act or abstinence, he is said to make a proposal." When a person to whom this proposal is made indicates his assent then offer is called accepted and gives rise to an agreement.

b. Competency of Parties:
Both the offeror and the acceptor must be competent parties to enter into contract. Some persons not have capacity to enter into a contract. Such persons are (i) minors
(ii) persons having unsound mind (iii) Person who is declared unfit by some other law.

c. Free Consent:
Free consent is present only when parties agree on a thing in the same sense. If the consent is obtained by such means i.e., by coercion, undue influence, fraud, misrepresentation or mistake, then that will not be called free consent. A person whose consent is not freely obtained may avoid or cancel the contract if so desires.

d. Consideration:
Consideration is something that moves from one party to the other and in return for that, other party fulfils part of obligation e.g., premium is a consideration and is paid by insured to insurer to bear risk of the insured's life.

APPLICABILITY OF SPECIAL PROVISIONS TO INSURANCE POLICY

The Life Insurance Agreement should contain the special provisions such as

a. Name of the insurer;
b. Name of the party who wants to insure;
c. Description of the risks to be covered;
d. The amount of premium;
e. The term of insurance;
f. The sum assured.

ii. Life Insurance Contract and Date of Risk;
The risk of the insurer starts from the date of contract. Life Insurance Companies issue prospectus and invite public to apply for insurance. Sometimes agents are also appointed to approach prospective insured. The prospective insured fills up the proposal form and submits to the insurance company. If the company accepts the proposal form, then it becomes a contract. The contract is complete only when the first premium is paid. Premium is generally paid in advance. Premium payment is generally considered as the proof of policy. But in certain conditions, there are certain conditions to be fulfilled before the contract is complete. Following are the methods of paying premium:

a. Proposal form is sent along with provisional receipt to company as proof of premium payment ;

b. Proposal form is sent and receipt for premium produced later;

c. Proposal form is sent without premium.

In case (a), Proposal form is sent along with premium payment receipt. Since premium is paid in advance, it will be taken as an offer by company and acceptance comes. If the insured fulfils other conditions like medical fitness etc. contract is complete from the date of medical examination.

In case (b), since premium is not paid in advance, the date of payment of premium and delivery of policy will be date of contract.

In case (c), since premium is not yet accepted, the contract will be complete from the date of delivery of policy document only.

In this case, this delivery does not mean physical delivery only. Even constructive delivery is also sufficient. It means as against insurer, delivery is complete when he puts the policy

in mail, addressed to the insured by affixing proper stamps. It may be mailed to his insured or to his agent for delivery to insured. The delivery may be conditional or unconditional. Conditional means the insurer can set the conditions for the insured and he has to comply with those conditions. The contract is complete only upon the compliance of conditions.

4.42.8 PRINCIPLES OF LIFE INSURANCE CONTRACT

Life Insurance Contract is a contract of good faith. If the insured has any knowledge of such facts which may influence the decision of insurer, he must disclose those facts in the proposal form in good faith. This concept must be present throughout the life of the contract.

Any change in the original condition must be communicated to the insurer. Life Insurance is a contract known as *uberrimaefidi*. It means the perfect good faith and no concealment of any fact. In insurance, insured must follow the perfect good faith towards the insurer. Both the parties must depend upon each other for information or knowledge of facts. The insurer has to trust the representations of the insured and proceed upon the confidence that the latter does not conceal any fact to mislead the insurer. Misrepresentation, non-disclosure or fraud in any document, leading to acceptance of risk, automatically discharges the insurer from all liabilities under the contract. The Insurance Act, 1938, however, provides that no policy can be called in question after a period of two years from the date of its issue, on the ground that any statement in the proposal or related document was false or incorrect. But this rule has an exception when the insurer can prove that this misrepresentation or non-disclosure was a material fact and was fraudulently made and the policy holder knew about the falsehood of the statement or has made the statement recklessly without caring to know whether it is true or false. It is in the interest of the insured to disclose all the material facts to the Corporation to avoid any hardship when the claim arises.

PRINCIPLE OF INSURABLE INTEREST

Life Insurance contract is not a contract of indemnity like other insurance contracts as in case of fire and marine insurance. Indemnity means that insurance is valid upon the amount of actual loss suffered by the insured and the loss must be due to the risk insured. The excess payment in case of contract of indemnity is considered as wager and against public policy. It applies to all insurance except life insurance. The Life Insurance contract provides for the payment of a definite sum. The loss on the death of the insured cannot be quantified. The insurer is bound to pay according to the terms and conditions mentioned in the policy document. The payment has no relation to financial loss to the family upon the death of the insured. Whether the death of the insured has caused any financial loss to the beneficiary or not is immaterial consideration for the insurer at the time of making payment on the death of insured. Insurer cannot deny liability for the sum insured. Life

Insurance is a contract to pay a definite sum of money on the happening of an event. If an insured dies, the person who is a nominee need not demonstrate or prove that direct financial loss has resulted from insured's death. He/she will get the money according to contract of assignment. Beside protection, there is an investment aspect also in the life insurance. In endowment policy, which is for a limited period, if the insured dies before maturity of policy his claimant can get the amount of policy and if he survives up to the date of maturity of policy he himself can get the amount of policy.

Indemnity in life insurance means that sum insured is accepted as the estimated value of loss, because actual loss cannot be measured and payment of sum assured is sure on death or expiry of insurance period. The value is declared by insured at the time of making contract and there is no need to compare value of actual loss with insured value. So it is concluded that life insurance is not a contract of indemnity as other non-life insurance contracts are.

The purpose of insurance is to protect the insured against losses resulting from hazards beyond one's control. Insurable interest must be present in every contract of insurance. It is sometimes said that insurance is nothing but a gambling. It enables a person to take a chance of receiving a large sum of money on the occurrence of a contingency such as fire to his property or by paying a small amount of premium. But this is not correct assumption. The principle of indemnity states that the insured shall not collect more than the actual value of loss. But the important condition in insurance contract is that the insured must have insurable interest. The principle of indemnity and insurable interest distinguish an insurance contract from wager or gambling.

As it is very difficult to calculate the monetary value of human life, the Principle of indemnity cannot be strictly applied to Life Assurance Contract.

PRINCIPLE OF UTMOST GOOD FAITH

Life Insurance requires that the principle of utmost good faith should be preserved by both the parties to the contract i.e. insurer and the insured. The insurer and the insured must be of the same mind at the time of contract because the risk cannot be correctly measured in its absence. They must disclose all the material facts affecting risk to each other.

The material facts in life insurance are age, income, health, residence, family details, occupation, and plan of insurance etc. The insured should disclose not only those facts which he feels are relevant but all the relevant facts should be disclosed. It is the duty of both the parties to disclose all the material facts which are going to influence
the decision of the insurance. In the absence of utmost good faith, the contract will be voidable at the option of the person who has suffered loss due to non-disclosure of any fact. The intention non-disclosure amounts to fraud and unintentional disclosure amounts to voidable contract.

The facts which do not affect the validity of the policy are as follows:

i. The disclosure in regard to universal facts
ii. The facts which are superfluous to disclose by reason of any condition.
iii. The facts which reduce the risk of the insurer.
iv. The facts which are waived by the insurer.
v. The facts which are known to the insurer in the course of the business.

PRINCIPLE OF WARRANTY

In Life Insurance those representations which are contained by the policies and expressly or impliedly forming the part of the contract are known as warranties. The representations means any information which a person gives to the insurer during negotiations for effect insurance contract. The representations may be material non-material as explained earlier. If the representation is material and it is false, it provides a good basis to treat the contract as void or voidable at the option of the insurer. The warranties are the basis of the contract of insurance of all kinds. If any statement given the proposal is false, the contract shall be null and void and the premium paid by the insured may be forfeited by the insurer. The warranties may be informative and promissory. The informative warranties are very important in life insurance contract as in this the proposer is to disclose all the material facts to the insurer to the best of his knowledge and belief. Promissory warranties are the future warranties which mean these are only based on future expectations and intentions.

The policy should contain that the personal statements and proposals should be the basis for contract. Any breach of warranty leads to render the contract voidable at the option of other party provided there is no fraud. If there is any element of fraud, the contract will be void.

PRINCIPLE OF CAUSA PROXIMA

The effective cause which leads to loss is called proximate cause. It is the real and actual cause of loss. The insurer will pay

compensation only if the cause of loss is insured; otherwise he will not compensate. Principle of causa proxima is not applied in Life insurance because the insurer is bound to pay the amount of insurance whatever may be the cause of death. Death may be accidental or natural. So this principle is not of much relevance in life insurance, but there are few instances when this principle of proximate cause is observed in the life insurance also. These instances are as follows :

a. Accidental death:

In accidental benefit policies extra amount is paid if the cause of death is accident. In this case the cause of death is of special significance.

b. Suicide:

If insured commits suicide within one year of the policy or there was intention to commit suicide; then the payment of claim would be restricted only up to the interest of the third party in policy, provided the interest was expressed, at least one month before the suicide.

c. War Risk;

Policies may be issued by inclusion or exclusion war and aviation risks.

4.42.9 OBJECT OF LIFE INSURANCE

Life has always been full of uncertainties. To be economically secure against the possible uncertainties that future should be secure, should have foresight and resourcefulness. In the old times, there was no agency to provide any financial protection to the nominees of deceased in case of eventualities. Risks to life and properties of all kinds were very great. Insurance provides compensation and financial help in the event of death and premium is charged by the insurer as the price thereof. The basic object of insurance is to reduce suffering on the happening of a contingent event. This object is achieved by the principle of cooperation. The loss suffered by an unfortunate is being distributed over the community at large. The loss on the death of insured can only be compensated to the members of the family of the deceased up to the extent of the amount of policy plus bonus if any. Otherwise the loss of human life cannot be quantified. The fundamental object of life insurance is to furnish protection against financial needs occasioned by disability, old age and death. It is also called income replacement insurance.

In addition to the object of protection against uncertainties of life risks, there is also an element of investment in Life Insurance. In Life Insurance an individual needs to be protected in the maintenance of savings through a sound investment plan quite as much as one need to be protected against the contingencies of death and disability. The object of protection is fulfilled through life insurance cover. The insured is protected to the extent of policy amount in event of premature death. It is the most important device or plan developed for providing family security on voluntary basis. One cannot stop death because it is certain but suffering of financial losses caused by the death of a person can be managed to stop by way of life insurance.

In life insurance, the insured is required to pay premium at regular intervals. This payment of premium is a type of investment with the insurer. With the payment of every premium the amount of investment increases. This element of investment is not there is fire and marine insurance because these are the contracts of indemnity whereas life insurance is

not an indemnity contract, it is a contingent contract. Under the fire and marine insurance, the insurer's objective is to get protection of compensation only in case of loss of insured subject matter. The payment of premium is not returned after expiry of the period of contract. So investment element is always missing in case of fire and marine insurance.

Life policies are generally for a longer period and in case of premature death, the compensation is paid to the family of the insured and if policy gets matured, the amount is paid to insured along with interest and bonus. The insured get lump sum amount along with return on his premium payments.

4.42.10 PROCEDURE OF EFFECTIVE LIFE INSURANCE POLICY

The Life Insurance business was nationalised on 19th January, 1956 and Life Insurance Corporation of India became the only body to carry on the business of life insurance. Before nationalisation, there were large number of Indian and foreign companies carrying on the insurance business privately. The Life Insurance Corporation is carrying on its business through its large network of branches and agents. It is totally under the ownership and control of the Government of India. Life Insurance Corporation was set up on 1st September, 1956. But now government has permitted the private companies to enter in this field. The following procedure has to be followed to effect Life Insurance Policy:

1. Filling up a Proposal form:
   Life Insurance policies generally taken through authorised agents of the Life Insurance Corporation and other Insurers/Insurance Companies. The person who wants to take the policy is required to fill up a prescribed proposal form which is provided by the agent or can be had free of cost from any branch of Life Insurance Corporation (LIC) and other Insurers. This form contains all the information required from the applicant to process the Life Insurance. The form is in the form of a question containing various questions from the Applicant. These questions are related to Name, Address and Occupation of the proposer, family details and health of the proposer, date of birth and age of the proposer (insured), policy amount, mode of premium payment, type of policy required, name of the nominee etc.

The Proposer (insured) is expected to furnish true and fair details and correct information in the proposal form because any mis-statement will lead to make the contract voidable. Life Insurance Contract is like other contracts enforceable at law and it requires absolute and utmost good faith on the part of both the parties i.e. the insurer and the insured. The proposer must not conceal any material information required to be given in the proposal form. Sometimes it is also required to give reference of such persons who know about the health and other family details of the insured.

2. Proof of Age:

   The proposer is also required to submit his/her proof of age along with the proposal form. For this it can be a copy of school certificate or certified copy of an entry in the Birth register of the Municipal Committee or maintained by any other Government department or service book maintained by the employer etc. When the insurer is fully satisfied as to the validity of the proof of age, he will issue a certificate admitting age.

3. Medical Examination:

   After receipt or proposal form in the office of Life Insurance, the proposer is required to get himself medically examined from the approved doctor of the Life Insurance Company. The proposal form is sent to the approved doctor for medical report of the prospective insured and prospective insured is required to appear before the doctor for medical examination. The doctor after examination forwards the report to the insurer's office for further action. The Insurance Company/Insurer is at liberty either to accept or reject the proposal on the basis of medical report of the proposer. This rule may be relaxed for certain categories of Government employees and for insurance policies up to a certain extent.

4. Agent's Report:

   The Life Insurance agent is the person authorised by the Insurance Company/Insurer. He helps the proposer in advising him regarding the type of policy suitable for particular person, rate of premium chargeable on various policies mode of payment of premium and technical details of Life Insurance contract. He is also required to furnish the confidential report about the proposer in the prescribed form. The report contains the facts about the proposer, his health, financial position and other particulars relevant for the contract of insurance. He is supposed to give impartial and correct information about the proposer. On the basis of reports the further action is taken by the insurer to effect insurance.

5. Acceptance of Proposal:

   On the basis of the information mentioned in the proposal form, medical report, agent's confidential report and other enquiries from the references, the proposal is considered by the Insurer for acceptance or rejection. The insurer makes and assessment of risk, on the basis of available information and reports. On the basis of volume and possibility of risks, premium rate is determined. Proposal is accepted only if it seems favourable to the Insurance Company. After acceptance of proposal, acceptance letter is sent to the insured stating the conditions to be fulfilled by the insured in the due course. Premium notice is also despatched along with acceptance letter.

6. Payment of First Premium:

   On the basis of premium notice, the insured deposits the amount of first premium and the Insurer becomes liable from the day on which it is paid. The contract of insurance becomes complete on the payment of first premium. Generally, the first premium is paid along with the proposal form. The policy may lapse on account of non-payment of premium within prescribed time frame. The Insurer/Insurance Company issues receipt acknowledging the payment of premium.

7. Issue of Policy:

   On the payment of first premium, the contract of Life Insurance comes into existence. Insurance policy is not issued immediately. It is prepared in proper form duly stamped, signed by authorised official to the Insurance Company/Insurer and finally issued to the insured. The whole process requires a few days' time. The Life Insurance Policy bears the seal of the Corporation/Company and contains all details, terms and conditions of life insurance contract. It also contains details of risks covered and other rules governing the validity of the policy.

4.42.11 KINDS OF LIFE INSURANCE POLICIES

Life Insurance Corporation provides various kinds of policies which can be classified as under:

I. On the Basis of Duration of Policy:

1. Whole Life Policies
2. Endowment Policies

II. On the Basis of Method of Premium Payment:

1. Single Premium Policy
2. Level Premium Policy

III. On the Basis of Participation in Profits:

1. With Profit Policies
2. Without Profit Policies

IV. On the Basis of Number of Lives Insured:

1. Single Life Policy
2. Joint Life Policy

V. On the Basis of Method of Payment of Premium:

1. Instalment or Annuity Policies
2. Lump sum Policies.

Check your progress: 42

Discuss life insurance policy.

Lesson End Activity:

Collect pamphlets containing information on various life insurance policies.

LESSON-43
MARINE INSURANCE

CONTENTS

4.43.1 Meaning and definition of marine insurance

4.43.2 Subject matter of marine insurance

4.43.3 Fundamental principles of marine insurance

4.43.4 Importance of marine insurance

4.43.5 Warranties in marine insurance

4.43.6 Types of marine insurance

Check your progress: 43

Lesson End Activity

The history of marine insurance is very old. The first insurance firm was started in 13th century by a person named Lombards. During 1766, the hoteliers of Italy and London started this business. Lord Edward Lloyd started the publication of a newspaper Lloyds News in which information regarding the arrival and departure of ships used to be given. In 1774, the other member of Lloyds Association started in a legal manner the marine insurance business through the firm named as 'Syndicate'.

Marine insurance is concerned with overseas trade. Foreign trade involves transport of goods from one country to another country by ship. There are many dangers during the trans-shipment. The persons, who are importing the goods, would like the safe arrival of their goods. The shipping company wants the safety of the ship. So, marine insurance covers all types of risks which can occur during transit.

4.43.1 MEANING AND DEFINITION OF MARINE INSURANCE

Marine insurance insures all types of risks which can occur during transit. It may be called a contract in which the insurer undertakes to indemnify the insured in a manner and to the extent thereby agreed upon against marine losses.

A few definitions are given as under:

1. Marine Insurance Act, 1963 (Section 3):
   "A contract of marine insurance is a contract whereby the insurer undertakes to indemnify the assured in a manner and to the extent thereby agreed, against marine losses, that is to say, the losses incidental to marine adventures."

2. Arnold:

   "A contract whereby one party for an agreed consideration, undertakes to indemnify the other against loss arising from certain perils and sea risks to which a shipment and other interests in a marine adventure may be exposed during a certain voyage or a certain time."

3. Insurance Act, 1938 [Section 2 (B):

   "Marine insurance business means the business of effecting contracts of insurance up on vessels of any description, including cargoes, freight and other interests which legally insured in or in relation to such vessels, cargoes, freights, goods, wares, merchandise or property of whatever description insured for any transit by land or water or both and whether or not including warehouse risks or similar risks in addition to or as incidental to such transit and includes any other risks customarily included among the risks insured against in marine insurance policies."

On the basis of above definitions it may be concluded that marine insurance covers the perils of sea as well as inland risks relating to the cargoes, ships, and freight, etc.

A marine insurance is a contract whereby the insurer undertakes to indemnify the insured in a manner and to the extent thereby agreed against the marine losses. It means the losses incidental to marine losses. It is a contract of indemnity. The risks insured against are those commonly known as perils of the sea such as collision of one ship against another ship, rocks, storm etc. and fire as well as action of the master or crew of the ship. Thus, it is a device to secure protection from loss or damage to property while in shipment.

Section 2 (13) A of the Insurance Act 1938, defines marine insurance as:

"Marine insurance business means the business of effecting contracts of insurance upon vessels of any description, including cargoes, freights and other interests which legally insured in or in relation to such vessels, cargoes, freights, goods, wares, merchandise or property of whatever description insured for any transit by land or water or both and whether or not including warehouse risks or similar risks in addition to or as incidental to such transit and includes any other risks customarily included among the risks insured against in marine insurance policies."

The above definition lays down various kinds of marine insurance.

The ship and cargo during the travelling are exposed to several perils. There risks may arise due to number of reasons. Similarly sometimes the owner of the goods may promise to pay the freight only, when the cargo is safely delivered at its port of destination. So marine insurance can be in respect of ship, of cargo or of freight.

4.43.2 SUBJECT MATTER OF MARINE INSURANCE

Following points are included in the subject matter of marine insurance:

a. Cargo insurance:

The insurance which is related for the safety of goods is known as cargo insurance. Generally, goods are insured according to their value but sometimes some percentage of profit is also included in the value. There are different types of cargo policies:

i. The Special policy: It is related with one shipment only.

ii. Reporting or Open Cargo policy: This type of policy covers all shipments made by an exporter over a long period of time.

iii. Floating Policy: It is like an open cargo policy but differs from it only in respect of the method of paying· the premium. In this type of policy the value of the future shipment is estimated and premium is deposited with the company.

b. Hull Insurance:

In hull insurance, the ship is insured against the perils of the sea such as collision against a rock, storm, sinking or burning of the ship.

c. Freight Insurance:

The shipping company has an interest in freight. The freight may be paid in advance or on arrival of goods. The shipping company will not get freight if the goods are not delivered safely at the destination. The shipping company may insure the freight to be received, which is known as freight insurance.

4.43.3 FUNDAMENTAL PRINCIPLES OF MARINE INSURANCE

1. Principle of utmost good faith:

The contract of marine insurance is based on utmost good faith on the part of the insurer and insured. The insured should disclose all the material information relating to insurance before the insurer. If the insured misrepresent some facts or withheld some facts about the marine insurance, the insurer can avoid the contract. Similarly, if the insurer does not inform the subject matter of the insurance contract, then the contract can be terminated.

2. Principle of Insurable Interest:

In marine insurance, the insurable interest is very essential. The following persons have insurable interest.

a. The owner of the goods in his goods.

b. The owner of the ship in his ship.

c. The master and crew of the ship have an insurable interest in respect of their wages.

d. The ship company in its freight.

e. The travellers in their luggage and goods.

f. The trustee in the trust goods.

g. The reinsurer in his goods.

h. A creditor who has advanced money on the ship or goods has an insurable interest to the extent of his debt.

3. Principle of Indemnity:

Insurance company compensates loss but allows no profit out of it. It means that the insured will be compensated only to the limit of loss suffered. He will not be allowed to earn profit from marine insurance. The insurance company undertakes to compensate the insured in cash and not to replace the cargo or the ship. There is one exception to the principle of indemnity in marine insurance. Some profit margin is also allowed to be included in the value of the goods. This is based on the assumption that insured will earn profit when the goods reach at their destination.

4. Principle of Causa Proxima:

This is a Latin phrase which means proximate cause. It means that cause which, in a natural and unbroken series of events, is responsible for a loss or damage. So insurer is not liable:

i. for any loss due to wilful misconduct of the insured.

ii. for loss due to delay.

iii. for loss which are normal and due to natural wear and tear.

Causa proxima is the cause proximate in efficiency and not necessarily the cause nearest in time. The cause which is truly proximate is that which is proximate in efficiency. (Land Shaw, Layland Shipping Co. Vs. Norwich Union Fire Insurance Society).

5. Warranties:

It is very necessary to follow all the implied warranties in case of marine insurance. If any of these warranties is not fulfilled, the other party may avoid the contract. These warranties may be oral or in writing. Following are the important warranties:

a. **Legality of the Venture:** The venture should be legal. If journey is illegal due to some cause, it will be relieved of the legal liabilities. So the conduct of the venture and its purpose must be legal under the law of insurance of the country and international laws.

b. **Seaworthiness:** It means reasonable fitness in all respects to survive the normal course of its proposed use. So the ship must be seaworthy at the commencement of the journey. A ship is considered to be seaworthy if it has been completely repaired, the master and staff is present and there is sufficient fuel in the ship, so that it can face the routine sea perils of the sea.

c. **Non-deviation:** The ship should follow the normal routes. If the ship deviates from normal routes without legal reasons, the insurer is free from responsibility. But prescribed route can be changed in certain exceptional cases.

6. Principle of Mitigation of Loss:

An insured must take reasonable care to reduce the loss i.e., maintain it. He must act as if the property was not insured. For example, if a ship is insured against sinking or fire, the insured must take all reasonable steps to keep loss to the minimum. He is supposed to take all the steps which a man of ordinary prudence would take under the circumstances.

7. Principle of Subrogation:

According to the doctrine subrogation, after the insured is compensated for the loss caused the damages, to the property insured by him, the right of ownership of such property passes on to the insurer. If the damaged property has any value left or the lost property is recovered, that cannot be allowed to remain with the insured because in that case he (insured) will realise more than the actual loss which is against the principle indemnity. Thus, the doctrine of subrogation means in effect substitution of the insurer in place of the insured as the rightful claimant of the rights, possession, etc.

4.43.4 IMPORTANCE OF MARINE INSURANCE

The importance of Marine Insurance is manifold. The development of international trade is closely linked with Marine Insurance. Increase in the volume of trade is also closely linked with Marine Insurance as it assures to indemnify the insured against loss, damages and expenses occasioned in connection with ship, cargo and freight. Marine Insurance is not like fire insurance in which only one risk of fire is covered. It covers so many perils of sea. The perils may include sinking of ship, fire, collision etc. It protects all the parties engaged in the business like ship owner, cargo owners and the shipping company. There are so many clauses in the Marine Insurance. Warehouse to warehouse clause covers all the risks from the time the goods leave warehouse and till they are delivered safely to the consignee’s warehouse. All the risks at various stages of journey are covered. On insuring the risks the exporters and importers are relieved of the risk of such losses during voyage. Marine risks cover all types of perils of marine voyage like fire, war perils, thieves (pirates), restraints and detainments of crew members and other types of risks as may be designated by the policy.

4.43.5 WARRANTIES IN MARINE INSURANCE

Warranties are the statements of facts and not merely the conditions to the contract. Warranty is that by way the insured undertakes some particular things shall or shall not be done or some conditions will be fulfilled or whereby he affirms or negatives the existence of particular state of facts. Warranties are the more strict conditions. A contract becomes voidable if warranties are not followed or fulfilled. Warranties may be oral or written. These are of two types:

(i) Express Warranties;

(ii) Implied Warranties.

Express Warranties: These warranties are expressly incorporated in the policies by reference and clearly explained in detail.

Implied Warranties: These warranties are not expressed in the policy in detailed written form but are understood by the parties to the contract. These implied warranties are also binding on the contracting parties as express warranties.

In Marine insurance implied warranties are as follows:

(i) Legality of the venture.

(ii) Seaworthiness of ship.

(iii) Non-deviation.

These warranties are very important for the contract of marine insurance. All the contracting parties must comply with these warranties literally. The underwriter of insurance may avoid any claim or liability for claim from the date of breach of such warranties.

4.43.6 TYPES OF MARINE POLICIES

Marine insurance is believed to be oldest form of insurance. It is concerned with the overseas trade conducted through sea routes. Marine risks generally relate to the ship or cargo. The traders and owners of ship always like to ensure the safe arrival of their cargo and ships. Marine insurance covers a large number of risks.

The important policies are discussed below which are issued in order to meet different demands of the insured. These are:

1. Voyage Policy:

This policy is issued to cover the risk from the port of departure up to the port of destination, no matter how long time it may take. The policy ends when the ship reaches the port of arrival. This type of policy is generally taken for cargo. The liability of the insurer continues during landing and reshipping of goods.

2. Time Policy:

Under this policy, the insurance is effected for a specified period of time only e.g. from 10:30 a.m. of January 2, 2001 to 10:30 a.m. of 1st January, 2002. Time policies are generally issued for one year although it may be for more or less than one year.

3. Mixed Policy:

This policy is the mix of voyage and time policy. The elements of both policies are combined in the mixed policy. This policy is issued for ships operating on a particular route and for a fixed period. The premium is comparatively lower in this category of insurance. This policy is suitable for hull and cargo insurance.

4. Floating Policy:

Floating policy is generally taken by merchants who regularly despatch or receive goods to insure all the cargoes expected to be shipped within a stipulated period by one policy.

5. Cargo Policy:

This type of policy is taken by the insured for the shipment of particular cargo only.

6. Blanket Policy:

This type of policy is taken by the insured for covering risks within the particular time and place. In this type of policy, the insurance is effected for certain amount and the premium is paid on the whole of the amount insured in the beginning of t policy, without any knowledge of the value of the cargo or hull for which the insurance cover is required.

7. Freight Policy:

Freight is the payment received for transportation of goods. The freight receiver, to protect the freight to be received, purchases the policy called freight policy.

8. Valued and Unvalued Policies:

In valued policy, the value of the policy is determined at the time of contract and also written on the face of the policy. The value which is decided is called insured value and, therefore, there is no need of partial loss.

9. Single Vessel and Fleet Policies:

A policy may be single vessel policy or a fleet policy. When the whole fleet is insured under one policy it is called fleet policy and when one single ship is insured, it is called single vessel policy. The advantage of such a policy is that the owner of several ships can insure old and weak ships under the same policy.

10. Declaration Policy:

Under declaration policy the insured takes out insurance for the maximum amount that he considers would be at the risk during the period of policy. This policy gives a better protection in those cases when the value of cargo fluctuates from time to time.

11. Port risk policy:

This policy is issued to cover all the risks involved when the ship is anchored in the port. The insured gets compensation for any kind of loss occasioned by him on the port itself.

12. Policy Proof of Interest (P.P .1. Policy) or Wager Policy:

This type of policy is issued to a person who has no insurable interest in the subject matter of the insurance and, thus in effect, is simply betting with the insurance to that he will suffer a loss. Legally this type of policy cannot be issued. If the Insurer does not honour the claim of the loss the insured cannot get it through the court because such a policy is void and simply a gambling contract. Wager policy is also known as Honour policy.

13. Composite Policy:

A policy may be undertaken by more than one underwriter. In this policy the liability of each underwriter is separate and distinct. This is called composite policy.

14. Block Policy:

Block policy covers both land and sea risks.

Check your progress: 43

What is marine insurance? What risks does it cover?

Lesson End Activity:

Collect information about marine insurance companies.

LESSON - 44

FIRE INSURANCE

CONTENTS

4.44.1 Meaning and definition of fire insurance
4.44.2 Importance of fire insurance
4.44.3 Fundamental principles of fire insurance contracts
4.44.4 Characteristics of fire insurance
4.44.5 Kinds of fire insurance policies
Check your progress: 44
Lesson End Activity
Let Us Sum Up

Fire Insurance has gained tremendous importance in the world of modern business. It is a device to compensate the insured for the loss caused by fire. In the Fire Insurance, the insurer distributes the burden of fire losses to all the members of the insurance community. It relieves the insured from the risks of loss caused by fire. In fire insurance, the insurer undertakes to compensate the insured against all losses caused by fire to the property or assets of the insured, in consideration of premium paid by the insured. The fire insurance does not protect only against real losses but it also provides certain consequential losses.

Fire insurance does not have a long history. It came into existence when there was a huge fire in 1660 in London. This fire lasted for 4 days and 4 nights, burnt over 436 acres of ground and destroyed over 13,000 houses. This was the most disastrous fire in the history and a loss of then 10 crores pounds was estimated. This great fire gave birth to fire insurance. Keeping in view this loss, a firm called ‘Sun Fire House’ was established in 1710 to cover the losses of fire.

Fire insurance is a cooperative tool to share the loss which is due to fire. It distributes heavy fire losses of a few numbers of individuals over a larger number of persons. As we know that the whole society is exposed to the risk of fire but it cannot be known in advance as to who is going to suffer in any particular year. Therefore, the heavy burden of uncertainty hangs over the head of every individual. Fire insurance removes this uncertainty of loss by protecting all those members of the society who insure against the fire.

All those who are exposed to fire hazards pool their premium, out of which the actual victims of fire are compensated. So the burden of fire losses is spread over a large number of persons who have taken fire policies.

4.44.1 MEANING AND DEFINITION OF FIRE INSURANCE

A fire insurance is an agreement between insurer and the insured, under which the insurer agrees to indemnify the loss caused by fire, to the insured, in consideration of certain payment, called premium.

DEFINITIONS

V.R. Bhushan and Prof. R.S. Sharm:

A fire insurance may be defined as an agreement whereby one party, in return for a consideration, undertakes to indemnify the other party against financial loss which he may sustain, by reason of certain defined subject- matter being damaged or destroyed by fire or other defined perils up to an agreed amount.

T.R. Smith:

Fire insurance may be defined as "a contract whereby the insurers, in return for a consideration, known as premium, undertake to indemnify the insured against financial loss which he may sustain, by reason of certain defined property, known as the property insured, being damaged or destroyed by fire or other perils within a stated period of the liability of insurer, being limited to a specified amount, called the sum insured."

Fire Insurance has also been defined under Section 2 of the Indian Insurance Act, 1938, as follows:

"Fire insurance business means the business of affecting, otherwise than incidentally the some other class of insurance business, contracts of insurance against loss by or incidental to fire or other, the occurrence customarily included among the risks insured against in fire insurance policies."

In the definitions above mentioned, the phrase 'Perils insured against' has a special importance.

The following are the main characteristics.

1. Loss by Fire:

The term 'fire' means a visible flame or glow accompanied by heat. In Fire Insurance 'Fire' has a different meaning. In Fire Insurance the term 'fire' means hostile fire which is destructive in nature but not the friendly fire which is used for cooking food or for fun. The hostile fire is generally uncontrollable. It generates heat and light both. In the real sense, the fire means actual fire which is accidental and not intentional fire.

A fire insurance policy makes provisions to indemnify losses caused by hostile fire and not friendly fire. The friendly fire can take the turn of hostile fire, once it goes beyond the limits assigned to it. The insurance company does not accept any claim, so long as the fire is friendly. If the fire is friendly or controllable and no ignition results, the damage to the property insured or other property by overheating, cracking or smoke are not compensated by the insurer.

2. Loss by Lightning of Clouds:

   Lightning of clouds is the discharge of atmospheric electricity when clouds pass speedily with lot of sound generation. But this is not included in the term fire and the damages caused by lightning are not loss by fire. But eventually this type of damages is also covered by insurance policy in practice.

3. Saving of Property:

   The fire insurance also undertakes to make good the loss resulting from saving the insured property from complete destruction by fire. This loss may be the damage of household articles etc.

4. Fire should be accidental:

   Any loss caused by fire with some purpose or intention is not to be indemnified by the insurer. The fire should be accidental. If the goods are destroyed by fire accidently without controlling during the course of cooking, the loss is treated as unintentional and is covered under the policy. The object of fire insurance is to indemnify the insured against the accidental loss not intentional loss by fire.

4.44.2 IMPORTANCE OF FIRE INSURANCE

The fire insurance is of immense importance in the present-day commerce and business environment. Business properties like factories, godowns, administrative buildings, raw materials, semi-finished and finished goods, all are exposed to fire risks. Any accidental fire may cause havoc to the business properties. The fire not only destroys the business assets but it may result into closure of business for quite a long time, which may lead to loss of business trading profits. The business activity is suspended for a long time. For the continuity of any business, protection of property from fire is vital. Fire insurance provides financial help in case of any loss to the property of the insured. It also provides for the consequential loss including loss of profit due to closure of business on the occurrence of fire and during reconstruction period.

Fire insurance is also very important for general public. The individuals can also get fire insurance policy cover for household goods against the risks of fire. People become mentally and financially secure by insuring their personal assets. Fire has been taking heavy toll on life and property every year. Insurance is for compensation of 1oss and not for prevention of loss. Every step can be taken to minimise or eliminate it by various

agencies engaged in this business to prevent the loss. Fire insurance companies stimulate the installation of protective devices by granting soft loans. They also help in installation of fire-fighting devices.

FIRE INSURANCE CONTRACT

Contract of fire insurance is a contract of indemnity according to which the insurer promises to indemnify to the insured for the losses arising out of fire. In consideration of this contract, the insurer charges some premium. Fire insurance policy is taken for a definite period, generally for one year. If there is no loss due to fire during the specific period, the insurance company will not pay anything and if some losses are caused during the insured period by fire the actual losses are compensated to the limit of the amount insured (whichever is less). For example, Mr.X, a businessman insured his shop for Rs. 30,000. Due to fire there is a loss of Rs. 20,000, insurance company will pay only Rs. 20,000. If the actual loss has been Rs. 14,000 then only Rs. 14,000 will be paid but if the loss is to the limit of Rs. 40,000, the insurance company will pay only 30,000. Thus, the insurance company pays the amount insured or actual loss, whichever is less. Due to· this reason, we can say that Fire Insurance Contract is based on the principle of indemnity. It does not help in controlling or preventing fire but it is a promise to compensate the loss.

FIRE :

For getting compensation two conditions must be satisfied. are:

a. Firstly, there should be actual fire or ignition. If there is a loss of material etc. due to smoke, it is not the example of fire. So the reason of the fire is not important but there should be actual fire.

b. Secondly, the fire should be accidental and not intentional.

4.44.3 FUNDAMENTAL PRINCIPLES OF FIRE INSURANCE CONTRACT

All the essentials of general contract are applicable to the fire insurance contract but following are the main principles of Fire Insurance Contract:

1. Principle of utmost good faith:

   Contract of insurance is a contract of utmost good faith. It is a condition of every fire insurance contract that both the parties - the insured and the insurer - should show utmost good faith towards each other in regard to the contract. It is the duty of the insured that he should make clear all the important points with regard to the subject matter of the insurance so that the insurer may correctly estimate the risk involved. The insured should give information regarding construction of the house, environment, and possibility of catching fire and possible measures that can be taken in case of fire. If the insured knowingly does not disclose the main points, in that case, the insurance company can avoid the contract, when it comes to know this fact.

Failure to make disclosure of material facts makes the contract of insurance voidable at the discretion of the insurer.

2. Principle of Insurable Interest:
It is the most important general principle of insurance. The insured must have insurable interest in the property which he wants to insure. Insurable interest means some pecuniary interest in the subject matter of insurance contract. Without such interest, the Contract will be regarded as a gambling policy and therefore void. It must be lawfully clear that insured has an interest in the preservation of the thing, so that he will suffer financially on the happening of the event against which he has insured. In case of fire insurance, insurable interest must be present both at the time of taking the policy and at the time of making claim. The following persons have insurable interest in the subject-matter concerned:

a. The owner of the property
b. A partner has an equitable interest in the firm's property.
c. A creditor has an insurable interest in the property on which he has lien for the debt.
d. An agent has insurable interest in his principal's goods.
e. A bailee can insure any property bailed.
f. A trustee has insurable interest in the property put trusteeship.
g. An insurer has insurable interest in respect underwritten for the purpose of reinsurance.

3. Principle of Indemnity:

Another important principle in of insurance of property like fire insurance is that of indemnity. A contract of fire insurance is a contract of indemnity under which insurer or underwriter promises to indemnify the insured in case any financial loss suffered by him on the happening of the event.

4. Principle of Subrogation:

The principle of subrogation is based on the principle of indemnity. It means the right of one person to stand in place of another. The insured can realise only the actual amount of loss or damages to the property insured. If the damaged property has left with some value or if the insured is allowed to retain that property, he can realise more than the actual loss which is against the principle of indemnity. The insured is allowed to proceed against the third party, if he recovers the damages from that party, the insurer is relieved of liability. If the insured has received the full amount of loss, then any sums received from the third party belong to the insurer.

5. Principle of Cause Proxima:

   This principle provides that the cause of fire must be taken into account. Proximate cause is very important in fire insurance. The insurer always tries to find out the proximate cause of damage to the property, which is subject matter of insurance, while paying a claim. If the property insured is burnt by the fire was preceded and brought into operation by an excepted peril, the legal position depends upon whether the excepted peril was the proximate cause of fire or not.

6. Principle of Personal Contract:

   A fire insurance contract is a personal contract. Therefore, the insurance company should have full knowledge about the behaviour and character of the insured. The fire insurance policy cannot be assigned to anybody without due permission of the company. If the possession of the goods is transferred to a third person, the company has a right to avoid the contract of insurance.

4.44.4 CHARACTERISTICS OF FIRE INSURANCE

1. The contract of fire insurance is a contract of indemnity and the insured cannot claim anything more than the value of goods or properties lost or damaged by fire or the amount of policy, whichever is less.
2. The contract of insurance is the outcome of the offer made by the insured and acceptance by the insurer or insurance company. As such, contract of fire insurance is the result of an offer made by insured and its acceptance by the insured.
3. Fire insurance policy is issued for a lawful consideration i.e. premium.
4. In case of fire insurance, the insured must have insurable interest in the goods or properties insured against fire, both at the time when the policy is taken and also at the time when the loss occurs and the claim is filed for compensation.
5. Premium is required to be paid at the time of taking policy.
6. Fire insurance policies are insured usually for one year duration but in some cases for shorter periods also.
7. The scrap or whatever is left of the goods or properties after damage or destroyed by fire, automatically pass on to the hands of the insurer after the payment of the claim under fire insurance.
8. The loss must be outcome of fire or ignition only.

9. The cause of the fire is immaterial for a fire insurance claim to be admitted. If the fire has been caused due to fraud or misconduct on the part of the insured, the loss will not be indemnified. But the loss caused by fire which occurred due to negligence of the insured or his servants is covered under fire insurance.

10. The fire insurance also includes indirect risks such as: comprehensive risks, consequential risks caused by fire, and reinstatement or rehabilitation risks which occur after the fire destroys the goods or properties.

11. The claim may be settled in cash or by reinstating or rehabilitating the goods or properties damaged by fire under the fire insurance.

SCOPE OF FIRE INSURANCE

Section 2 of the Indian Insurance Act, 1938 while defining fire insurance, states the scope of fire insurance to include:

1. Fire insurance business is different from other insurance business in operation and covers the risks caused by fire.

2. In addition to the risks caused by fire, it also includes other reasons and occurrences which can customarily be included among risks insured under fire insurance contracts.

4.44.5 KINDS OF FIRE INSURANCE POLICIES

Fire insurance is a co-operative device to share the losses which are due to fire. It distributes heavy fire losses of a few individuals over a large number of persons.

All those who are exposed to fire hazards pool their premium out of which the actual victims of fire are compensated. So the burden of fire losses is spread over a large number of persons who have taken fire policies. The fire policies are the legal documents of evidence of the contract between the Insurance Company and the Insured in which various terms and conditions are settled.

The various fire insurance policies which are issued in order to meet different demands of the insured are discussed below:

1. Valued Policy:

   Under this policy, the value of the property to be insured is determined at the time of taking the policy. In this case, the insurer undertakes to pay the insured, the amount of the value of the property declared in the policy. In case of total loss, the insurer will have to pay this amount quite independent of the market value or the actual value of the property at the time of the loss. Thus, the amount payable under a valued policy may be more or less than the actual value of the property.

2. Valuable Policy:

   Under this type of policy, the claim amount is based on the market price of the damaged property not at the agreed price fixed at the time of taking the policy. In this case, the principle of indemnity is strictly followed. The amount of loss is determined at the time and place of loss.

3. Specific Policy:

   Under this type of policy the insurer undertakes to insure for a definite amount. In case of loss, the insurance company pays the full amount of actual loss provided it does not exceed the specific sum mentioned in the policy. The value of the property insured has no relevance here and the insured sum set a limit up to which the loss can be compensated. For example, if a person has taken a Fire Insurance Policy of Rs. 10,000 against a property worth Rs. 15,000 and he suffers a loss of Rs. 7,000, he can realise the whole loss of Rs. 7,000. If his loss is Rs. 10,000 only, then full amount can be recovered and if the loss exceeds Rs. 10,000, then only Rs. 10,000 can be recovered.

4. Excess Policy:

   When there is a fluctuation in the stock from time to time in that case it is not possible to take one specific policy. In this case insured takes two policies - one ‘First Loss Policy’ and second ‘Excess Policy’. The 'First Loss Policy' will cover that value of stock below which the value never goes. 'Excess Policy' will cover the maximum additional amount by which the stock rise at different periods. For example, a businessman’s stock varies between Rs. 40,000 and Rs. 60,000, he may take the ‘First Loss Policy’ for Rs. 40,000 and Excess Policy of Rs. 20,000.

5. Stock Declaration Policy:

   Under this policy, the insured takes out insurance for the maximum amount of stock that he considers would be at risk during the period of policy. This type of policy will give better protection when stock fluctuates very sharply from time to time.

6. Floating Policy:

   A floating policy is taken to cover the risk of goods lying at various places and the goods are taken in and out of these places. At the time of fire, the estimated value of the goods is calculated and the losses are indemnified. The rate of premium is fixed after taking into account the total amount which would have been payable as premium for separate specific policies for goods lying at different places. This policy is useful to cover fluctuating stocks lying at various places.

7. Comprehensive Policy:

   Comprehensive policy may be issued to cover up all types of risks like fire, lightning, burglary, riots, explosion, strikes, thunderbolt etc. This type of policy is also known as all risk policy. However, such type of policy is not common in our country. The term comprehensive does not mean that every type of risk is covered. There may be many limitations and exclusions as provided in Insurance Act. This policy is beneficial to insurer because he can charge higher premium for this type of policy. It is also beneficial for insured as he is protected against so many specific dangers.

8. Consequential Loss Policy:

   In this type of policy, the insurance company agrees to compensate the insured for the loss of profit which he suffers due to the dislocation of business caused by fire. The loss of profit is determined on the basis of loss of sales. It is also known as 'Loss of Profit' insurance policy. The consequential loss policy takes into account both tangible and intangible losses. Originally in the fire insurance contract, only tangible losses were used to be underwritten by the insurer. The intangible interest was not indemnified. But in the modern context, the consequential losses are also provided. This policy provides to indemnify the losses in regard to loss of profit during closure of business, expenditure in respect of increase in working cost and standing charges such as rents, rates, salaries and other expenses which are fixed liabilities of the insured during the period of reconstruction. This policy holder gets compensation for the financial loss which he may sustain due to closure of business after the fire. The measure of indemnity used to be on the specific percentage of loss of profit based on the past experience. Nowadays, the loss is estimated for both loss of profit based on reduction in turnover and loss due to increase in cost of working to create the business conditions as they were before the fire.

9. Average Policy:

   If the average clause is applicable to a policy, it is called Average Policy. Average clause is added to penalise the insured in case of under-insurance. The compensation payable is proportionately reduced if the value of the policy is less than the value of the property.

10. Building in the Course of Construction:

    Like floating policy, two types of policies are available for buildings in course of construction and machinery in course of installation. The floating policy is issued for a sum insured initially and it goes on increasing as the construction of building work progresses. The premium increases on sum insured on pro-rata basis. The policy is issued for the total value of construction. The calculation of premium is based on half the tariff rates.

11. Adjustable Policy:

    This type of policy is issued for a specific period on the existing stock. The premium is paid in full at the time of taking a policy. If there is any variation in the value of stock, the insured intimates the Insurance Company. On receipt of information, the insurer endorses the policy accordingly and the premium is adjusted. In this type of policy, the amount of policy changes from time to time due to which the premium is settled finally at the expiry of the policy.

12. Blanket Policy:

    This type of policy covers both fixed and current assets of insured manufacturer. No distinction between fixtures, machinery, building and stock is made.

13. Replacement Policy:

    Replacement policy provides that compensation will be according to the replacement price. For this, the new asset should be similar to that which has been lost. The amount of compensation will depend upon the market price of the new assets so that it is replaced without additional cost to the insured. That is why this policy is also called 'new for old policy' because the old property is replaced by new property. Such types of policies are issued only in respect of fixed assets like plant, building, machinery etc.

Check your progress: 44

Discuss the significance of fire insurance.

Lesson End Activity:

Collect information on the types of claims generally made under fire insurance.

Let us sum up:

- Life insurance is a contract in which insurer, in consideration of a premium, undertakes to pay a certain sum of money either on the death of the insured to his/her nominees or on the expiry of fixed period to him/her
- A contract of insurance, in addition to fulfilling the basic or essential characteristics of a valid contract, i.e., proposal, acceptance, free consent, competency of the parties, also observes some of the fundamental principles of insurance, such as:

- Insurable interest
- Utmost good faith
- Indemnity
- Subrogation
- Contribution
- Proximate cause
- Mitigation of loss, etc.

- "Life Insurance is the business of effecting contracts of insurance upon human life including any contract whereby the payment of money is assured on death except death by accident on the happening of any contingency dependent on human life and any contract which is subject to the payment of premium for a term dependent on human life."

- Marine insurance insures all types of risks which can occur during transit. It may be called a contract in which the insurer undertakes to indemnify the insured in a manner and to the extent thereby agreed upon against marine losses.

- A fire insurance is an agreement between insurer and the insured, under which the insurer agrees to indemnify the loss caused by fire, to the insured, in consideration of certain payment, called premium

UNIT – V

LESSON - 45

COMPANY

CONTENTS

5.45.1 Meaning
5.45.2 Characteristics of a company
5.45.3 Corporate Veil
5.45.4 Kinds of companies
Check your progress: 45
Lesson End Activity

AIMS AND OBJECTIVES

This unit aims at educating the students about companies. Companies are an important form of business ownership and have a wide array of concepts to be understood. After reading this unit, the students will be able to

i. Define a company
ii. Differentiate between various types of companies
iii. Explain about Memorandum of Association, Articles of Association, Prospectus, Directors and company meetings

INTRODUCTION

A company means a group of persons associated together for attaining some common interest or objective. There are various kinds of companies established for a wide variety of purposes. The Companies Act, 1956 governs these companies.

5.45 .1 MEANING

A company means a group of persons associated together for the attainment of a common goal either social or economic or both. The term registered company means a company incorporated under the Companies Act, 1956 or some other earlier companies act. Companies incorporated under the Companies Act, 1956 are mostly business companies but they may also be formed for promoting art, charity, research, religion, commerce, or any other useful purpose.

The law relating to companies in India is contained in the Companies Act, 1956, as amended up-to-date. The latest amendment to the Act was made in 2001 by the Companies (Amendment) Act, 2001.

DEFINITION OF COMPANY

Lindley. L.J defines a company as "an association of many persons who contribute money or money's worth to a common stock, and employ it in some common trade or business, and who share the profit or loss arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share; shares are always transferable although the right to transfer them is often more or less restricted".

A company is a voluntary association of persons:

A company, in broad sense, may mean an association of individuals formed for some common purpose [Smith vs. Anderson, (1880) Ch. D. 247]. But it is a voluntary association of persons. It has capital divisible into parts, known as shares. At the same time it is an artificial person created by a process of law. It has a perpetual succession and a common seal. It exists only in contemplation of law, i.e., it is regarded by the law as a person, just as a human being, Ram or Shyam, is a person.

An artificial person – has no body or soul:

A company has no body, no soul and no conscience nor is it subject to imbecilities of the body. It is not visible, other than to the eyes of law. These physical disabilities make a company an artificial person. But then a company really exists and it is not a fictitious entity.

On incorporation, a company becomes a body corporate or corporation with perpetual succession and a common seal. It also acquires a personality distinct from its members.

5.45.2 CHARACTERISTICS OF A COMPANY

1. Separate legal entity;
   A company is regarded as an entity separate from its members by law. It has an independent corporate existence. The company's money and property belong to the company and not to the share holders.

2. Limited Liability:
   A company may be a company limited by shares or a company limited by guarantee. In a company limited by shares, the liability of members is limited to the unpaid value of the shares. In a company limited by guarantee, the liability of members is limited to such amount as the members may undertake to contribute to the assets of the company in the event of the company being wound up.

3. Perpetual Succession:
   A company is an artificial person created by law with a perpetual succession. It is created by a process of law and can be put to an end only by a process of law. Members may come and go, but the company can go on forever. (until dissolved). It continues to exist even if all its human members are dead.
   Perpetual succession means that a company's existence continues irrespective of the change in the composition of its membership.

4. Common Seal:
   Since a company has no physical existence, it must act through its agents and so all such contracts entered into by its agents must be under the seal of the company. The common seal acts as the official signature of the company.

5. Transferability of shares:
   The capital of the company is divided into parts called shares. These shares are, subject to certain conditions, freely transferable, so that no shareholder is permanently or necessarily required to remain as the shareholder of the company.

6. Separate property:
   As a company is a legal person, distinct from its members, it is capable of owning, enjoying and disposing of property in its own name. Although its capital and assets are contributed by its shareholders, they are not the private and joint owners of its properties.

7. Capacity to sue:
   A company can sue (file case against in a court) and be sued in its corporate name. It may also inflict or suffer wrongs. It can in fact do or have done to it most of the things which may be done by or to a human being.

5.45.3 CORPORATE VEIL

From the juristic point of view, a company is a legal person distinct from the members who are the shareholders. This principle is known as "Veil of Incorporation" or "Corporate Veil". The court in general considers itself bound by this principle. The effect of this principle is that, there is a fictitious (imaginary) veil (and not a wall) between the

company and its members. It means that the company has a corporate personality which is different fromits members.

People started using this veil of corporate personality as a cloak/cover for fraud or improper conduct. Thus, it became necessary for the courts to break through or lift the corporate veil and look at the persons who are behind the company and who are the real beneficiaries of the corporate fiction.

Lifting of Corporate Veil:

The various cases/circumstances in which corporate veil has been lifted are as follows:

i. Protection of revenues:
The courts may ignore the corporate entity of a company where it is used for tax evation (JuggilalVs. Commissioner of Income Tax, 1969, Supreme Court 982). Tax planning may be legal, provided it is within the framework of law. No fictitious company can be used as a device for tax planning.

ii. Prevention of fraud or improper conduct:
The legal personality of a company may be disregarded where it is used for some fraudulent purpose like defrauding creditors or defeating or circumventing law.

iii. Determination of character of a company- (Deciding whether it is an enemy company):
A company may assume an enemy character when persons in *de facto* control of its affairs are residents in an enemy country. In such a case, the court may examine the character of persons in real control of the company and declare the company to be an enemy company.

iv. Company avoiding legal obligations:
Where the use of an incorporated company is being made to avoid legal obligations or where the company refuses to perform the necessary legal obligation, the court may disregard the legal personality of the company and proceed to take action against the members of the company.

v. Company is acting as an agent or trustee of the shareholders:
Where a company is acting as an agent for its shareholders, the shareholders will be liable for the acts of the company.

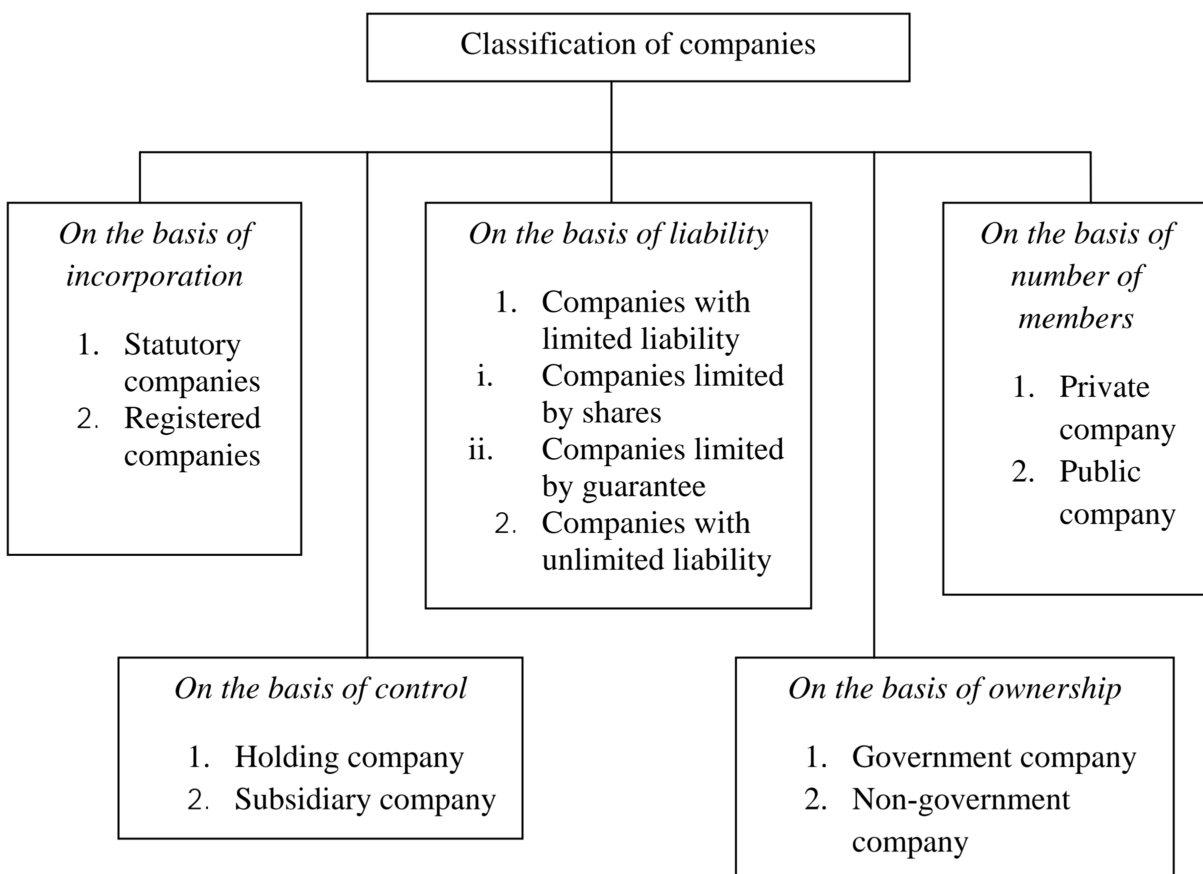
vi. Where the company is a sham (hoax):
The courts will lift the corporate veil where a company is only a cloak or hoax.

vii. Avoidance of welfare legislation:
Avoidance of welfare legislation is as common as avoidance of taxation. In such cases, the courts consider the problems arising out of such avoidance as due to negligence of shareholders and hence the veil will be lifted and the shareholders will be held liable.

viii. Protecting public policy:
The courts will lift the corporate veil to protect the public policy and prevent transactions which are against public policy.

5.45.4 KINDS OF COMPANIES (CLASSIFICATION OF COMPANIES)

Companies may be classified into various kinds on the following basis:



I. Classification on the basis of incorporation:

1. Statutory companies:
These are the companies which are created by a special Act of the legislature. E.g., Reserve Bank of India (RBI), State Bank of India (SBI), Life Insurance Corporation (LIC), Industrial Financial Corporation, Unit Trust of India (UTI).

These are mostly concerned with public utilities. E.g., Railways, Electricity companies. The provisions of the Companies Act, 1956 are applicable to these companies. Thus, these are the companies which are established by a special law or statute but are required to operate as every other organisation.

2. Registered companies:

These are the companies which are formed and registered under the Companies Act, 1956, or which were registered under any of the earlier Companies Acts. These are the most commonly found companies.

II. Classification on the basis of liability:

1. Companies with limited liability:

a. Companies limited by shares:

The liability of the members of this kind of company is limited to the amount unpaid on the shares. The liability can be enforced on the members. The members can be asked to pay the unpaid amount during the existence of the company or during the winding up of the company. If the shares are fully paid, the liability of the members holding such shares is nil. A company limited by shares may be a public company or a private company.

b. Companies limited by guarantee:

In this type of companies, the liability of the members is limited to a fixed amount which the members undertake to pay to the assets of the company in the event of its winding up. The liability of its members is limited. The Articles of such companies must mention the number of members with which the company is to be registered.

Companies limited by guarantee are not established for the purpose of profit but for the promotion of art, science, culture, charity and sports. They may or may not have a share capital.

2. Unlimited companies:

Section 12 of the Companies Act provides that any 7 or more persons in the case of public companies and 2 or more persons in the case of private companies may form an incorporated company with or without limited liability. A company without limited liability is known as an unlimited company. In case of such a company, every member is liable for the debts of the company, as in an ordinary partnership in proportion to his interest in the company. An unlimited company may or may not have a share capital. If it has a share capital, it may be a public or private company. It must have its own Articles of Association.

III. Classification on the basis of number of members:

1. Private companies:
A private company is normally what the Americans call as a "Close Corporation". According to Section 3, I (iii), a private company means a company which has a minimum paid up capital of Rs.1,00,000 or any other higher paid up capital as may be prescribed and the company Articles of Association states the following rules;

i. Restricts the right to transfer its share;

ii. Limits the number of its members to 50, not including its employee members, present or past;

iii. Prohibits any invitation to the public to subscribe for any shares in, or debentures of the company.

A private company must have its own Articles of Association which contains the conditions that are applicable to private companies.

2. Public companies:
A public company means a company:

i. Which has a minimum paid up capital of Rs.5,00,000 or any higher amount as prescribed by the Act.

ii. Which is not a private company and therefore the rules applicable to the private company do not apply to the public company.

Distinction between Private and Public companies:

Basis of distinction	*Private company*	*Public company*
1. Minimum capital	Must have a minimum paid up capital of Rs.1,00,000.	Must have a minimum paid up capital of Rs.5,00,000.
2. Minimum number	Minimum number of persons required to start a private company is 2	Minimum number of persons required to start a private company is 7
3. Maximum number	Maximum number cannot exceed 50	No restriction on maximum number
4. No. of directors	Must have at least 2 directors	Must have at least 3 directors

5. Restriction on appointment of directors	Directors need not file consent with the registrar to act as directors or sign an undertaking for their qualification share.	Directors must file consent with the registrar to act as directors or sign an undertaking for their qualification share.
6. Restriction on invitation to subscribe for shares	By its Articles prohibits any invitation to the public to subscribe for the shares in or the debentures of the company	Can invite the public to subscribe for the shares in or the debentures of the company
7. Transferability of shares and debentures	Right to transfer shares and debentures is restricted by the Articles	Shares and debentures are freely transferable
8. Special privileges	Enjoy some special privileges	Do not enjoy any special privileges
9. Quorum	If the Articles of a company do not provide for a larger quorum, 2 members personally present in the case of a private company is sufficient for a meeting of a company.	If the Articles of a company do not provide for a larger quorum, 5 members personally present in the case of a public company is sufficient for a meeting of a company.
10. Managerial remuneration	No restrictions are laid on the managerial remuneration in a private company	Total managerial remuneration in a public company cannot exceed 11% of the net profits

Special privileges enjoyed by a private company:

1. No. of members:
   A private company may have only 2 members.

2. Allotment before minimum subscription:
   A private company can allot shares before the minimum subscription is subscribed for.

3. Prospectus or Statement in lieu of prospectus:
   A private company may allot shares without issuing a prospectus or delivering a statement in lieu of prospectus.

4. Issue of new shares:
   When a public company issues new shares, after the expiry of 2 years from its formation or at any time after the expiry of 1 year from the date of first allotment of share, whichever is earlier, a private company has to offer these shares first to the existing equity shareholders pro rata. However, the members in a general meeting may, by a special resolution, decide otherwise. There is no such provision in case of private companies.

5. Kinds of share:
   A private company may issue share capital of any kind, and with such voting rights, as it may think fit.

6. Commencement of business:
   A private company can commence business immediately on incorporation.

7. Index of members:
   A private company need not keep an index of members.

8. Statutory meeting and statutory report:
   A private company need not hold statutory meeting or file with the Registrar the statutory report.

9. Demand for poll:
   Even one member having the right to vote and present in person or by proxy (if not more than 7 such members are personally present) may demand a poll. If the number of members present is more than 7, two members present in person or by proxy may demand a poll.

10. Managerial remuneration:
    The rule of overall maximum managerial remuneration does not apply to a private company which is not a subsidiary of a public company. In the case of a private company which is a subsidiary of a public company, the overall managerial remuneration must not exceed 11 per cent of the net profits.

11. Number of directors:
    A private company need not have more than 2 directors.

12. Rules regarding directors:
    The rules regarding directors of a private company are less stringent. For example, it is not necessary for a private company to file with the Registrar the consent of a director to act as such; the company may provide additional grounds for disqualification of directors and their vacation of office; a director can vote on a contract in which he is interested.

Legal position of a private company:

The legal position of a private company in most aspects is similar to that of a public company. Even if one member holds majority of shares in a private company, the private company is considered as a distinct person different from the member. Thus, a private company has got separate legal entity and considered as an artificial person.

Situations in which a private company becomes a public company:

A private company may become a public company by-

1. Conversion by default [Section 43]:
   If a private company does not follow the essential requirements of a private company, it stops to be called as a private company. It gets the status of a public company when it breaks the restrictions like not having more than 50 members, non-transferability of shares and no issue of shares to the public.

2. Conversion by operation of law [Section 43-A]:

a. Where not less than 25% of the paid up share capital of the private company is held by one or more public companies.

b. Where the average annual turnover of a private company is not less than such amount as prescribed by the Companies Act, 1956. At present this amount is Rs.10 crores or more for 3 consecutive financial years.

c. Where the private company holds not less than 25% of the paid up share capital of a public company having a share capital, the private company holding such shares will automatically become a public company.

d. Where the private company invites, accepts or renews deposits from the public, then the private company becomes a public company.

   A private company which is converted into a public company by operation of law is known as “Deemed Public Company”. Such converted companies have to inform the registrar of companies about their conversion within a period of 3 months.

3. Conversion by choice/volition [Section 44]:
   A private company can get itself converted into a public company if it wishes to become a public company. It can do so by altering its Articles of Association and deleting those rules relating to private company. The private company within 30 days of bringing about changes in the Articles of Association should register it with the registrar of companies.

[If a private company takes steps to increase its membership to at least 7 if it is below that number on the date of conversion and also increase the number of its directors to more than 2 if it is below that number].

Conversion of a public company into a private company:

A public company may be converted into a private company by passing a special resolution. The special resolution should be to change the Articles of Association of the company so as to give it the benefit of a private company. Such alteration will have effect only when they are approved by the Central Government. After getting the approval from the Central Government, the new Articles must be filed with the Registrar within a period of one month.

IV. Classification on the basis of control:
On the basis of control, companies may be classified as follows:

1. Holding company [Section 4(4)]:
A company is known as a holding company of another company, if it has control over that company.

2. Subsidiary company [Section 4(1)]:
A company is known as a subsidiary of another company when control is exercised by the latter (called holding company) over the former called a subsidiary company. A company is said to be a subsidiary of another company in the following cases:

Assumptions :

H = Holding company
S = Subsidiary company

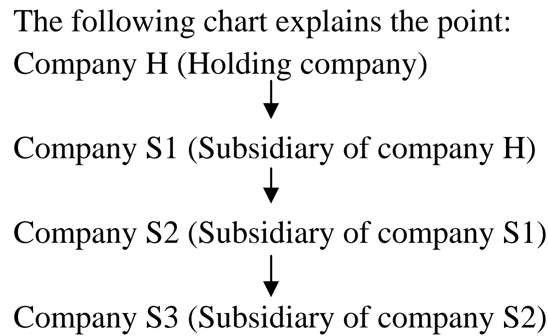
a. Company controlling composition of Board of directors:
Where a company (H) controls the composition of Board of directors of another company (S), then company S is known as the subsidiary of company H.

b. Holding of majority of shares:
Where a company (H) holds more than 50% of the nominal value of equity share capital of another company (S), company S here becomes the subsidiary of company H.

c. Subsidiary of another subsidiary:
Where a company (S) is a subsidiary of another company (H1) which is itself a subsidiary of the controlling company (H), the former (S) becomes the subsidiary of the controlling company (H).

Example:

Company S is a subsidiary of company H and Company S1 is a subsidiary of company S. Company S1 is a subsidiary of company H, by virtue of the above clause. If company S2 is a subsidiary of company S1, company S2 will be a subsidiary of company S and consequently also of company H, by virtue of the above clause.



Company S3 and company S2 are subsidiaries of company H.

V. Classification on the basis of ownership;

1. Government company:
   A government company means any company in which not less than 51% of the paid up share capital is held by:

   i. The Central government
   ii. Any State government or governments
   iii. Partly by the Central government and partly by one or more State governments.

2. Non-government company:
   It is a company controlled and operated by private capital.

Foreign Company [Sec.591(1)]:

It means any company incorporated outside India, which has an established place of business in India.

Example: If the representatives of a foreign company frequently come and stay in a hotel in India for purchasing raw material s or machinery and equipments, the foreign company has a place of business in India.

Associations not for profit [Sec.25]:

Some associations are established as limited companies for promoting commerce, science, religion, charity or any other useful purpose. Such companies do not have profit maximisation as their objective. Such companies are exempted from using the words Ltd., or Pvt. Ltd., behind their names.

One-Man company:

This is usually a private company in which one man holds practically the whole of the share capital of the company. In order to meet the statutory requirement of minimum number of members, some dummy members who are mostly his relatives or friends, hold just one or two shares each. A one-man company, like any other company, is a legal entity distinct from its members.

Check your progress : 45

What are the kinds of companies?

LESSON-46

INCORPORATION OF A COMPANY

CONTENTS

5.46.1 Method of forming an incorporated company
5.46.2 Certificate of Incorporation
5.46.3 Effects of Registration
5.46.4 Promoter
Check your progress: 46
Lesson End Activity

Before a company is formed, certain preliminary steps have to be taken and decisions have to be made regarding the following aspects:

i. Whether the company should be a private company or a public company
ii. Its total capital investment
iii. Whether to form a new company or to take over the business of an already established concern

All these steps are taken by certain persons known as promoters. They do all the necessary preliminary work required for the incorporation of the company.

5.46.1 METHOD OF FORMING AN INCORPORATED COMPANY [SEC. 12]

Any 7 or more persons, in case of a public company, and, 2 or more persons in case of a private company, associated for any lawful purpose may form an incorporated company. They shall subscribe their names to a Memorandum of Association (MoA) and also abide by the other formalities in respect of registration. A company so formed may be:

i. A company limited by shares, or
ii. A company limited by guarantee, or
iii. An unlimited company.

Companies limited by shares are the most popular among incorporated companies.

Documents to be filed with the Registrar:

The following documents which are properly prepared on stamped papers with the necessary fees are to be filed with the Registrar:

i. Memorandum of Association (MoA):
A duly signed MoA containing the details of the subscribers should be submitted.

ii. Articles of Association (AoA):
Where required, the AoA, signed by the subscribers must be filed. A public company limited by shares need not have its own Articles of Association.

iii. The Agreement:
The agreements which the company plans to enter into with any individual for appointment as its managing director or whole-time director must be prepared and filed [Sec 33(1)].

iv. A list of the Directors:
A list of directors who have agreed to become the first directors of the company must be prepared. This document along with the written consent has to be filed with the Registrar in the case of public company limited by shares.

v. A Declaration;
A Declaration stating that all the requirements of the Companies Act and other formalities relating to registration have been followed correctly. Such a declaration must be signed by any of the following persons;

- An Advocate of the Supreme Court or the High Court
- An Attorney or a Pleader who can appear before a High court
- A Secretary or a Chartered Accountant who practices full-time in India and who is engaged in the formation of the company
- A person named in the Articles as a director, manager or secretary of the company.

All the above documents have to be filed with the Registrar of companies of the state in which the company is going to be incorporated. Then, within 30 days of the date of incorporation, a notice containing the details about the Registered Office of the company must be given to the Registrar, who will record the details in the Register of companies.

5.46.2 CERTIFICATE OF INCORPORATION

When all the required documents are filed with the Registrar, the Registrar shall satisfy himself that all the statutory requirements regarding the registration have been complied with. The Registrar is not required to carry out any investigation regarding the details given in the documents. The Registrar retains all the documents with him and issues a Certificate of Incorporation.

By issuing this certificate, the Registrar certifies that the company is incorporated [Sec. 3].

Conclusiveness of the Certificate of Incorporation [Sec. 35]:

A certificate of incorporation given by Registrar to a company is the conclusive evidence that all the requirements of the Companies Act have been satisfactorily met by the promoters. The certificate concludes the following aspects:

i. That the requirements of the Act in respect of registration have been complied with
ii. That the association is a company authorised to be registered under the Act
iii. That the date given on the certificate of incorporation is the date of birth of the company

5.46.3 EFFECTS OF REGISTRATION [SEC. 34]

When a company is registered and a certificate of incorporation is issued by the Registrar, three important consequences follow:

i. The company becomes a distinct legal entity
ii. The company acquires a perpetual succession
iii. The company’s property is not the property of the shareholders

A private limited company can start business immediately after its incorporation. A public company has to get the certificate to commence its business.

5.46.4 PROMOTER

A Promoter is a person who does the necessary preliminary work required for the formation of a company. The first persons who control a company’s affairs are its promoters. It is they who conceive the idea of forming a company to attain specific goals. It is they, who take the necessary steps to incorporate the company, provide it with share and loan capital and acquire the property for the company. When these things have been done, they and over the control of the company to its directors. Sometimes, the promoters themselves are the directors of the company and hence they take the total control of the company as its directors.

Functions of Promoters:

The promoter of the company decides its name and ensures that it will be accepted by the Registrar of companies.

i. He settles the details of the company's MoA
ii. He nominates the directors, legal advisors, bankers, auditors, the secretary and the Registered Office of the company
iii. He arranges for the printing of the MoA and AoA
iv. He arranges for the registration of the company
v. In the case of public company, he prepares the prospectus and issues the same for raising capital through public issue of shares.

Legal Status:

A promoter is not a trustee or the agent of the company that is to be established by him. He occupies the peculiar position of the Quasi-trustee.

Check your progress:46

Who is a promoter?

LESSON - 47

MEMORANDUM OF ASSOCIATION

CONTENTS

5.47.1 Purpose of Memorandum
5.47.2 Contents of Memorandum
5.47.3 Alteration of Memorandum
5.47.4 Doctrine of Ultra Vires
Check your progress: 47
Lesson End Activity

Memorandum of Association is a document of great importance in relation to the proposed company. It contains all the fundamental conditions upon which the company is allowed to be incorporated. It is the "Charter of the Company". It defines *Raison d'etre* (reason for existence) of the company. It lays down the area of operation of the company. It also regulates the external affairs of the company in relation to outsiders. Its purpose is to enable the shareholders and all those who deal with the company to know about the operations of the company.

5.47.1 PURPOSE OF MEMORANDUM

- The prospective shareholders will know the purpose for which their money is going to be used by the company and what risks they are undertaking in making investment
- The outsiders dealing with the company shall know as to what the objects of the company are and know for certain their contractual relationship with the company.

Printing and signing of Memorandum [Sec. 15]:

The Memorandum of Association of a company shall be –

i. Printed,

ii. Divided into paragraphs numbered consecutively, and

iii. Signed by 7 subscribers in the case of public companies and 2 subscribers in the case of private companies.

Each subscriber shall sign (and add his address, description and occupation, if any) in the presence of at least 1 witness who shall attest the signature and shall likewise add his address, description and occupation, if any.

The Memorandum of Association printed on computer laser printers should be accepted by the Registrar for registration of a company, provided it is neatly and legibly printed.

Form of Memorandum [Sec. 14]:

The Memorandum of Association of a company shall be in such one of the Forms in Tables B, C, D and E in Schedule I to the Companies Act, 1956, as may be applicable to the case of the company, or in a Form as near thereto as circumstances admit.

5.47.2 CONTENTS OF MEMORANDUM (SEC.13)

The Memorandum of every company shall contain the following clauses (described as conditions of the company's incorporation)-

1. The name of the company, with 'Limited' as the last word of the name in the case of a public limited company and with 'Private Limited' as the last words of the name in the case of a private limited company.

2. The State in which the registered office of the company is situated

3. The objects of the company which shall be classified as-

a. the main objects of the company to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of the main objects; and

b. other objects of the company not included in (a).

4. In the case of companies (other than trading corporations) with objects not confined to one State, the States to whose territories the objects extend.

5. Limited liability: The Memorandum of a company limited by shares or by guarantee shall also state that the liability of its members is limited.

6. Share capital: In the case of a company having a share capital, the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount. In such a company each subscriber shall take at least one share and shall write opposite his name the number of shares he takes. The Memorandum of a company limited by guarantee shall also state that each member undertakes to contribute a certain sum to the assets of the company, if need be, in the event of its being wound up.

The Memorandum shall conclude with an 'association clause which states that the subscribers desire to form a company and agree to take shares in it.

These clauses are now considered in detail:

I. The name clause (Sec. 20):

The name of a company establishes its identity and is the symbol of its existence. A company may, subject to the following rules, select any suitable name-

1. Undesirable name to be avoided: A company cannot be registered by a name which, in the opinion of the Central Government, is undesirable. Broadly speaking, a name is undesirable and rejected if it is either-

a. too similar to the name of another company; or

b. Misleading, i.e., suggesting that the company is connected with a particular business or that it is an association of a particular type when this is not the case.

2. Injunction if identical name adopted: If a company gets registered with a name which resembles the name of an existing company, the other company with whom the name resembles can apply to the Court for an injunction to restrain the new company from adopting the identical name.

An injunction will not be granted to prevent the use of a purely descriptive word with a definite meaning and in common use. Where the names of the 2 companies contain a word which is in common use, its use cannot be restrained and even a very trifling distinction between their names will suffice to make them acceptable.

3. 'Limited' or 'Private Limited' as the last word or words of the name. The Memorandum shall state the name of the company with 'Limited' as the last word of the name in case of a public limited company, and with 'Private Limited' as the last words of the name in case of a private limited company. In case the company has been formed for the promotion of art, science, religion, etc., the Central Government may permit by a licence, the omission of the word 'Limited' or the words 'Private Limited' from the name.

The omission to use the word 'Limited' as part of the name of a company must have been deliberate and not merely accidental.

4. Prohibition of use of certain names: The Emblems and Names (prevention of Improper Use) Act, 1950 prohibits the use of or registration of a company or firm with, any name or emblem specified in the Schedule to that Act. The Schedule specifies, amongst others, the following items, i.e., the name, emblem or official seal of the United Nations Organisation, the World Health Organisation, the United Nations Educational, Scientific and Cultural Organisation, the Indian National Flag, the name, emblem or official seal of the Central Government and State Governments, the name, emblem or official seal of the President of India or Governor of any State.

5. Use of some key words according to authorised capital: If a company uses any of the following key words in its name, it must have a minimum authorised capital mentioned against the key words :

	Key words	*Required authorised capital Rs.*
1.	Corporation	5 crores
2.	International, Globe, Universal, Continental, Inter-Continental. Asiatic, Asia, being the first words of the name	1 crore
3.	If any of the words at (2) above is used within the name (with or without brackets)	50 lakhs
4.	Hindustan, India, Bharat, being the first word of the name	50 lakhs
5.	If any of the words at (4) above is used within the name (with or without brackets)	5 lakhs
6.	Industries/Udyog	I crore
7.	Enterprises, Products, Business, Manufacturing	10 lakhs

Publication of name (Sec. 147):

Every company shall-

a. paint or affix its name and the address of its registered office, the outside of every office or place in which its business is carried on,

b. have it engraved in legible characters on its seal, and

c. have its name and the address of its registered office mentioned in legible characters in all business letters, bill-heads, negotiable instruments, invoices, receipts, etc., of the company.

II. The registered office clause (Sec. 146):

Every company have a registered office from the day on which it begins to carry on business, or as from the 30th day after the date of its incorporation whichever is earlier. All communications and notices are to be addressed to that registered office. Notice of the situation of the registered office and every change shall be given to the Registrar within 30 days after the date of incorporation of the company or after the date of change. If default is made in complying with these requirements, the company and officer of the company who

is in default shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues.

The situation of the registered office of a company determines its domicile [Daimler Co. Ltd. vs. Continental Tyre & Rubber Co. Ltd., (1916) 2 A.C.307].

III. The objects clause [Sec. 13 (1)]:

The objects of a company shall be clearly set forth in the Memorandum, for a company can do what is within, or incidental to, the objects stated in the Memorandum. The objects clause both defines and confines scope of the company's powers and once registered, it can only be altered as provided by the Act.

The purpose of the objects clause is

i. to enable subscribers to the Memorandum to know the uses to which their money may be put, and
ii. to enable creditors and persons dealing with the company to know what its permitted range of enterprise or activities is.

The objects clause in the Memorandum of every company state-

a. *Main objects* of the company to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of the main objects, and
b. *Other objects* of the company not included in the above clause.

Further, in the case of a company (other than a trading corporation) whose objects are not confined to one State, the States to whose territories the objects extend has also to be stated.

A company, which has a main object together with a number of subsidiary objects, cannot continue to pursue the subsidiary objects after the main object has come to an end.

Incidental acts: The powers specified in the Memorandum must not be construed strictly. The company may do anything which is fairly incidental to these powers. Anything reasonably incidental to the attainment or pursuit of any of the express objects of the company will, less expressly prohibited, be within the implied powers of the company.

IV. The capital clause [Sec. 13(4)]:
The Memorandum of a company, having a share capital, shall state the amount of the share capital with which the company is to be registered and the division thereof into shares of a fixed amount. The capital with which a company is registered is called the 'registered', ''authorised' or 'nominal' capital. A company cannot issue more shares than are authorised for the time being by the Memorandum. The shares issued by a company can only be equity shares or preference shares, but they cannot have disproportionate rights (Secs.85 and 89). A private company which is not a subsidiary of a public company may issue shares of any kind and with disproportionate rights (Sec. 90).

V. The liability clause [Sec. 13(2)]:

The Memorandum of a company limited by shares or by guarantee shall also state that the liability of its members is limited. This means that the members can only be called upon to pay to the company at any time the uncalled or unpaid amount on the shares held by them, or up to the maximum of the amount which they have guaranteed. There is, however, one exception to this rule.

VI. The association clause [Sec. 13 (4)]:

The association clause states: "We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names." This is followed by the names, addresses and descriptions of the subscribers and the number of shares taken by each of them. Each subscriber has to take at least 1 share.

The Memorandum shall be signed by at least 7 subscribers in the case of a public company, and by at least 2 subscribers in the case of a private company. The signature of each subscriber shall be attested by at least 1 witness who cannot be any of the other subscribers.

5.47.3 ALTERATION OF MEMORANDUM

Alteration of conditions

I. Change of name:
By special resolution: A company may change its name by a special resolution and with the approval of the Central Government signified in writing. But a change of name which merely involves the deletion or addition of the word "Private" on the conversion of a public company into a private company or vice versa does not require the approval of the Central Government.

By ordinary resolution: Sometimes, through inadvertence or otherwise, a company is registered by a name which in the opinion of the Central Government, is identical with, or too nearly resembles, the name of an existing company. In such a case, the company-

a. may change its name, by ordinary resolution and with the previous approval of the Central Government,

b. shall change its name if the Central Government so directs within 12 months of its registration. When so directed by the Central Government the company shall, by ordinary resolution and with previous approval of the Central Government, change its name within a period of 3 months from the date of the direction. The above rule also applies to an existing company which is registered by a new name which is identical with, or too nearly resembles, the name of an existing company. If the company makes default in complying with any direction given by the Central Government in this regard, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 100 for every day during which the default continues.

Fresh certificate of incorporation (Sec. 23):

Where a company changes its name, the Registrar shall enter the new name on the Register in the place of the former name. It shall also issue to the company a fresh certificate of incorporation. The change of name shall be complete and effective only on the issue of such a certificate. The Registrar shall also make the necessary alteration in the Memorandum of Association of the company.

II. Change of registered office:

This may involve -

i. Change of registered office from one place to another state within a state

ii. Change of registered office from one State to another

Procedure of alteration:

1. Special resolution:

   A special resolution shall be passed at a general meeting so as to change the place of registered office from one State to another.

2. Confirmation by the Company Law Board:

   The alteration shall not take effect until it is confirmed by the Company Law Board on petition.

3. Notice to affected parties:

   Before confirming the alteration, the Company Law Board shall be satisfied that sufficient notice has been given to every person whose interest will be affected by the change, and that the consent of the creditors of the company has been obtained or their debts or claims have been discharged or secured.

4. Notice to Registrar:

   The Company Law Board shall cause notice of the petition for confirmation of the change to be served on the Registrar. The Registrar shall also be given a reasonable opportunity to appear before the Company Law Board and state his objections and suggestions, if any, with respect to the confirmation of the change.

5. Power of the Company Law Board to confirm change is discretionary:

   The Company Law Board may confirm the change, on such terms and conditions as it thinks fit.

6. Rights and interests of members and creditors to be taken care of:

   The Company Law Board shall have regard to the rights and interests of every class of the members and the creditors of the company.

7. Copy of special resolution and the order of the Company Law Board to be filed with the Registrar (Sec. 18).

A company shall file with the Registrar-

a. the special resolution passed by the company within one month from the date of such resolution;

b. a certified copy of the order of the Company Law Board confirming the change within 3 months of the order. The company shall also file a printed copy of the Memorandum as altered. The Registrar shall register the same and certify the registration within 1 month from the date of filing of such documents. The certificate shall be conclusive evidence that all the requirements of the Act with respect to change and the confirmation thereof have been complied with.

Effect of failure to register (Sec. 19):

No alteration of Memorandum shall have effect unless it has been registered in accordance with the provisions of Sec. 18. If the documents to be filed with the Registrar under Sec. 18 are not filed within the prescribed period, such alteration and order of the Company Law Board and all proceedings connected therewith shall become void and inoperative.

A certified copy of the order confirming the change shall be filed by the company with the Registrar of the State in which the registered office is to be transferred and he shall register the same. All the records of the company shall then be transferred to the Registrar of the State in which the registered office of the company is transferred.

III. Alteration of objects (Sec. 17)

The objects clause is the most important clause in the Memorandum of Association. The legal personality of a company exists only for the particular purposes of incorporation as defined in the objects clause.

The power of alteration of objects is subject to two limits, namely

i. substantive or physical limit, and
ii. procedural limit.

Substantive limit:

By Sec. 17 (1), the objects of a company may be altered by special resolution so as to enable the company-

a. To carry on its business more economically or more efficiently.
b. To attain its main purpose by new or improved means.
c. To enlarge or change the local area of its operations.
d. To carry on some business which may conveniently or advantageously be combined with the objects specified in the Memorandum

   In the following cases alteration of the objects clause was permitted

e. To restrict or abandon any of the objects specified in Memorandum;
f. To sell or dispose of the whole, or any part of the undertaking, or of any of the undertakings, of the company; or
g. To amalgamate with any other company or body of persons

Procedure of alteration:

i. Special resolution:

   A special resolution shall be passed at a general meeting so as to alter the objects company.

ii. Copy of special resolution to be filed:

   The company shall file with the Registrar the special resolution within 1 month from the date of the resolution with a printed copy of the Memorandum as altered.

iii. Certification of registration:

   The Registrar shall register the resolution and certify the registration under his hand within 1month from the date of the filing of the special resolution.

IV. Change in liability clause:

A. company limited by shares or guarantee cannot change its Memorandum so as to impose any additional liability on the members or to compel them to buy additional shares of the company unless all the members agree in writing to such change either before or after the change (Sec. 38).

V. Change in capital clause:

Changes in the capital clause which involve increase, reduction or reorganisation of capital can be carried out by passing special resolutions.

5.47.4 DOCTRINE OF ULTRA VIRES

A company has the power to do all such things as are

1. authorised to be done by the Companies Act, 1956 ;
2. essential to the attainment of its objects specified in the Memorandum ;
3. reasonably and fairly incidental to its objects [Foster vs. London Chatham & Dover Co. (1895) 1 Q.B. 711].

Everything else is ultra vires the company. 'Ultra' means 'beyond' and 'vires' means 'powers'. The term ultra vires a company means that the doing of the act is beyond the legal power and authority of the company. The purpose of these restrictions is to protect-

i. investors in the company so that they may know the objects in which their money is to be employed; and

ii. creditors by ensuring that the company's funds are not wasted in unauthorised activities.

Ultra vires act is void. If an act is ultra vires the company, it does not create any legal relationship. Such an act is absolutely void and even the whole body of shareholders cannot ratify it and make it binding on the company. It is not necessary that an act to be considered ultra vires must be illegal; it may or may not be [Anand Parkash vs. Asstt. Registrar, A.I.R. (1968) All. 22].

The main feature and facet of the doctrine of ultra vires is that a company being a corporate person should not be mucted (fined or punished) for its own acts or acts of its agents, if they are beyond its powers and privileges [Bhodani vs. Bank of Baroda, (1957) 27 Comp. Cas. 233]. Where the company exceeds its authority, the act is good to the extent of the authority and bad as to the excess. But if the excess cannot be separated from the authority conferred on the company by the Memorandum, the whole transaction would

be affected by the doctrine of ultra vires and would be void. But there is nothing to prevent a company from protecting its property.

Ultra vires the directors:

If an act or transaction is ultra vires directors (i.e., beyond their powers, but within the powers of company), the shareholders can ratify it by a resolution in a general meeting or even by acquiescence provided they have knowledge of the facts relating to the transaction to be ratified. If an act is within powers of the company, any irregularities may be cured by the consent of the shareholders [Express Engg. Works Ltd., Re (1920) 1 Ch. 466].

Ultra vires the Articles:

If an act or transaction is ultra vires the Articles, the company can ratify it by altering the Articles by a special resolution. Again if the act is done irregularly, it can be validated by the consent of the shareholders provided it is within the powers of the company.

Check your progress:47

What is Memorandum of Association?

LESSON - 48

ARTICLES OF ASSOCIATION

CONTENTS

5.48.1 Contents of Articles
5.48.2 Alteration of Articles
5.48.3 Articles and Memorandum – their relation
5.48.4 Constructive notice of Memorandum and Articles
5.48.5 Doctrine of Indoor Management
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Lesson End Activity

The Articles of Association or just Articles are the rules, regulations and bye-laws for the internal management of the affairs of a company. They are framed with the object of carrying out the aims and objects set out in the Memorandum of Association.

The Articles are next in importance to the Memorandum of Association which contains the fundamental conditions upon which alone a company is allowed to be incorporated. They are as such subordinate to, and controlled by, the Memorandum.

In framing the Articles of a company care must be taken to see that regulations framed do not go beyond the powers of the company itself as contemplated by the Memorandum of Association.

5.48.1 CONTENTS OF ARTICLES

Articles usually contain provisions relating to the following matters:

1. Share capital, rights of shareholders, variation of these rights, payment of commissions, share certificates.
2. Lien on shares.
3. Calls on shares.
4. Transfer of shares.
5. Transmission of shares.
6. Forfeiture of shares.
7. Conversion of shares into stock.

8. Share warrants.
9. Alteration of capital.
10. General meetings and proceedings thereat.
11. Voting rights of members, voting and poll, proxies.
12. Directors, their appointment, remuneration, qualification, powers and proceedings of Board of directors.
13. Manager.
14. Secretary.
15. Dividends and reserves.
16. Accounts, audit and borrowing powers.
17. Capitalisation of profits.
18. Winding up.

Companies which must have their own Articles (Sec. 26):

The following companies shall have their own Articles, namely,

a. unlimited companies.
b. companies limited by guarantee.
c. private companies limited by shares.

The Articles shall be signed by the subscribers of the Memorandum and registered along with the Memorandum.

A public company may have its own Articles of Association. If it does not have its own Articles, it may adopt Table A given in Schedule I to the Act.

Regulations required in case of an unlimited company, a company limited by guarantee and a private company (Sec. 27):

1. Unlimited company:
   In the case of an unlimited company, the Articles shall state-

a. the number of members with which the company is to be registered, and
b. if it has a share capital, the amount of share capital with which the company is to be registered.

2. Company limited by guarantee:
   In the case of a company limited by guarantee, the Articles shall state the number of members with which the company is to be registered.

3. Private company:
   In the case of a private company having a share capital, the Articles shall contain provisions which -

   i. restrict the right to transfer shares,

   ii. limit the number of its members to 50 (not including employee-members), and

   iii. prohibit any invitation to the public to subscribe for any shares in, or debentures of, the company.

Adoption and application of Table A (Sec. 28):
There are three alternative forms in which a public company may adopt Articles:

1. It may adopt Table A in full.
2. It may wholly exclude Table A and set out its own Articles in full.
3. It may frame its own Articles and adopt part of Table A.

In other words, unless the Articles of a public company expressly exclude any or all provisions of Table A, Table A shall automatically apply to it.

Form of Articles in the case of other companies (Sec. 29):

The Articles of any company, not being a company limited by shares, shall be in such one of the Forms in Tables C, D, and E in Schedule I to the Act, as may be applicable, or in a Form as near thereto as circumstances admit. Further, such a company may include any additional matters in its Articles in so far as they are not inconsistent with the provisions contained in the Form in any of the Tables C, D, and E adopted by the company.

Form and signature of Articles (Sec. 30):

The Articles shall be

i. printed,
ii. divided into paragraphs, and
iii. signed by each subscriber of the Memorandum (who shall add his address, description and occupation, if any) in the presence of at least 1 witness who will attest the signature and likewise add his address, description and occupation, if any.

The Articles of Association printed on computer laser printer should be accepted by the Registrar for registration of a company provided they are neatly and legibly printed (Press Note, issued by the Department of Company Affairs, dated 22-6-1993).

5.48.2 ALTERATION OF ARTICLES

Companies have been given very wide powers to alter their Articles. The right to alter the Articles is so important that a company cannot any manner, either by express provision in the Articles or by an independent contract, deprive itself of the power to alter its Articles. Any clause in the Articles that restricts or prohibits alteration of Articles is invalid. If, for example, the Articles of a company contain any restriction that the company shall not alter its Articles, it will be contrary to the Companies Act and, therefore, inoperative.

Procedure of alteration (Sec. 31):

A company may, by passing a special resolution, alter its Articles any time. Again any Articles may be adopted which could have been lawfully included originally. A copy of every special resolution altering the Articles shall be filed with the Registrar within 30 days of its passing and attached to every copy of the Articles issued thereafter. Any alteration so made in the Articles shall, as valid as if originally contained in the Articles.

Limitations to alteration :

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1. Must not be inconsistent with the Act:

   The alteration of the Articles must not be inconsistent with, or go beyond, the provisions of the Companies Act. For example, the Articles cannot be altered so as to give power to a company to purchase its own shares.

2. Must not conflict with the Memorandum:

   The alteration of the Articles must not exceed the power given by the Memorandum, or conflict with the provisions of the Memorandum. If it does, it will be ultra vires and wholly void and inoperative.

3. Must not sanction anything illegal:

   The alteration must not purport to sanction anything which is illega1. But if it is legal and it is not clearly prohibited by the Memorandum, it may be held to be valid even where it alters the whole structure of the company.

4. Must be for the benefit of the company:

   The alteration must be made bona fide for the benefit of the company as a whole. That the power of alteration must be "exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities."

5. Must not in any way increase the liability of the existing members:

   The alteration must not in any way increase the liability of the existing members to contribute to the share capital of, or otherwise pay money to the company unless they agree in writing before or after the alteration is made. But where the company is a club or association, the Articles may be altered to provide for subscription or charges at a higher rate.

6. Alteration by special resolution only:

   The alteration can be made only by a special resolution. Even clerical errors in the Articles should be set right by a special resolution [Evans vs. Chapman, (1902) 18 L.T. 506].

7. Approval of Central Government when a public company is converted into a private company:

   The alteration in the Articles which has the effect of converting a public company into a private company can be made only if it is approved by the Central Government. Where this alteration has been approved by the Central Government, a printed copy of the Articles as altered shall be filed by the company with the Registrar within 1 month of the date of receipt of order of the approval.

8. Breach of contract:

   A company is not prevented from altering its Articles even if such an alteration would result in breach of some contract. The affected party may, however, file a suit for damages for the breach of contract.

9. Must not result in expulsion of a member:

   An assumption by the Board of directors of a company of any power to expel a member by amending its Articles is illegal and void. Any provision in the Articles conferring such a power on the Board of directors is repugnant to the various provisions in the Companies Act pertaining to the rights of a member in a public limited company.

10. No power of the Court to amend Articles:

    The Court has no power to amend or rectify the Articles even where there is a mistake or drafting error which the Court would rectify in the case of any other contract [Evans vs. Chapman. (1902) 18 L.T.R. 506]. The Court can only declare some clause to be ultra vires [Scott vs. Frank Scott (London), Ltd .. (l940) Ch. 794].

11. Alteration may be with retrospective effect:

    The Articles may be altered with retrospective effect and the fact that some members suffer a detriment does not make it void.

5.48.3 ARTICLES AND MEMORANDUM - THEIR RELATION

The Articles are subordinate to Memorandum:

The Articles cannot give powers to a company which are not conferred by the Memorandum nor can they purport to create rights which are inconsistent with the Memorandum. This is so because the object of the Memorandum is to state the purpose for which the company has been established, while the Articles provide the manner in which the internal management of the company is to be carried.

The Memorandum must be read in conjunction with Articles:

This is the case when it is necessary-

a. to explain any ambiguity in the terms of the Memorandum, or

b. to supplement the Memorandum upon any matter about which it is silent except as regards matters which must by Statute be provided by the Memorandum.

The Articles may explain or supplement the Memorandum, but cannot extend or enlarge its scope.

The terms of the Memorandum cannot be modified or controlled by the Articles:

If, however, there is any ambiguity in the Memorandum, the articles may be referred to for clarification. But so far as the fundamental conditions in the Memorandum are concerned, they cannot be explained with the aid of the Articles.

ARTICLES AND MEMORANDUM - DISTINCTION

Memorandum of Association	Articles of Association
It is the charter of the company indicating the nature of its business, its nationality, and its capital. It also defines the company's relationship with outside world.	They are the regulations for the internal management of the company and are subsidiary to the Memorandum.
It defines the scope of the activities of the company, or the area beyond which the actions of the company cannot go.	They are the rules for carrying out the objects of company as set out in Memorandum.
It, being the charter of the company, is the supreme document.	They are subordinate to Memorandum. If there is conflict between the Articles and the Memorandum, the latter prevails.
Every company must have its own Memorandum.	A company limited shares need not have Articles of its own. In such a case, Table A applies.

There are strict restrictions on its alteration. Some of the conditions of incorporation contained in it cannot be altered except with the sanction of the Company Law Board.	They can be altered by a special resolution, to any extent provided they do not conflict the Memorandum and Companies Act.
Any act of the company which is ultra vires the Memorandum is wholly void and cannot be ratified even by the whole body of shareholders.	Any act of the company which is ultra vires the Articles (but is intra vires the Memorandum) can be confirmed by the shareholders.

5.48.4 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

Every outsider dealing with a company is deemed to have notice of the contents of the Memorandum and the Articles of Association. These documents, on registration with the Registrar, assume the character of public documents. This is known as constructive notice of Memorandum and Articles.

Office of Registrar is a public office:

The Memorandum and the Articles are open and accessible to all. It is the duty of every person dealing with a company to inspect these documents and see that it is within the powers of the company to enter into the proposed contract. Likewise special resolutions, when registered with the Registrar and particulars of charges registered with the Registrar, become public documents, so that an outsider is on notice of their contents in the same way as he is the Articles and the Memorandum [Irvine vs. Union Bank of Australia, (1877) 2 App. Cas. 366].

Presumption that outsider has read Memorandum and Articles. Lord Hatherley observed in this regard in Mahony vs. East Holyford Mining Co., (1875) L.R 7 H.L. 869 as follows:

“But whether he actually reads them or not it will be presumed that he has read them. Every joint stock company has its Memorandum and Articles of Association.....open to all who are minded to have any dealings whatsoever with the company and those who so deal with them must be affected with notice of all that is contained in these two documents.”

5.48.5 DOCTRINE OF INDOOR MANAGEMENT

There is one limitation to the doctrine of constructive notice of Memorandum and the Articles of a company. The outsiders dealing with the company are entitled to assume that as far as the internal proceedings of the company are concerned, everything has been regularly done. They are presumed to have read these documents and to see that the

proposed dealing is not inconsistent therewith, but they are not bound to do more; they need not inquire into the regularity of the internal proceedings as required by the Memorandum and the Articles. They can presume that all is being done regularly. This limitation of the doctrine of constructive notice is known as the "doctrine of indoor management" or the rule in Royal British Bank vs. Turquand, or just Turquand Rule.
The doctrine of constructive notice protects the company against outsiders whereas the doctrine of indoor management seeks to protect outsiders against the company.

Royal British Bank vs. Turquand, (1856) 6 E. & B. 327. The directors of a company had issued a bond to T. They had the power under the Articles to issue such bond provided they were authorised resolution passed by the shareholders at a general meeting of company. No such required resolution was passed by the company. Held, T could recover the amount of the bond from the company on the ground that he was entitled to assume that the resolution been passed.

The gist of the rule is that persons dealing with limited liability companies are not bound to inquire into the regularity of the internal proceedings and will not be affected by irregularities of which they had no notice.

The rule is based on public convenience and justice:

First, the Memorandum and the Articles are public documents. They are open to inspection by everybody. But the details of internal proceedings are not open to public inspection. An outsider is presumed to know the constitution of a company, but not what may or may not have taken place within the doors that are closed to him.

Secondly, the lot of creditors of a limited liability company is not a particularly happy one: it would be unhappier still if the company could escape liability by denying the authority of the officers to act on its behalf.

Check your progress:48

Compare Articles and Memorandum.

LESSON - 49

PROSPECTUS

CONTENTS

5.49.1 Definition

5.49.2 Objects of registration of prospectus

5.49.3 Contents of Prospectus

Check your progress: 49

Lesson End Activity

In order to finance its activities, a company needs capital which is raised by a public company by the issue of a prospectus inviting deposits or offers for shares and debentures from the public. A private company is prohibited from making any invitation to the public to subscribe for any shares in, or debentures of, the company. Hence it need not issue a prospectus.

The central theme of a prospectus, from the money raising point of view, is that it sets out the prospects of the company and the purpose for which the capital is required. The prospectus is the basis on which the prospective investors form their opinion and take decisions as to the worth and prospects of the company.

5.49.1 DEFINITION

Sec. 2 (36) defines a prospectus as "any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate." In simple words, any document inviting deposits from the public or inviting offers from the public for the subscription of shares or debentures of a company is a prospectus.

Prospectus to be in writing:
A prospectus must be in writing. An oral invitation to subscribe for shares in, or debentures of, a company, or deposits is not a prospectus. Likewise, an advertisement in television or a film is not treated to be a prospectus.

Invitation to public:
A document is not a prospectus unless it is an invitation to the public to subscribe for shares in, or debentures of, a company. But if the document satisfies the condition of invitation to the public, it is a prospectus even though it is issued to a defined class of the

public [Nash vs. Lynde, (1929) A.C. 158]. Thus an advertisement which stated that "some shares are still available for sale according to the terms of the company which may be obtained on application" was held to be a prospectus as it invited the public to purchase shares [Pramatha Nath Sanyal vs. Kali Kumar Dutt, A.I.R. (1925) Cal. 714]. If, however, the invitation is made to a small circle of friends of the directors or the existing shareholders, it is not an offer to the general public.

Offer to the public, i.e., public issue:
Whether shares have been 'offered to the public' is a matter of fact and will depend on the circumstances of a particular case.

Dating of prospectus (Sec. 55):

A prospectus issued by or in relation to an intended company, may be dated and that date is, unless the contrary is proved, taken as the date of publication of the prospectus.

Signing of prospectus:
In case the prospectus is issued by intended company, it has to be signed by the proposed directors of company or by their agents authorised in writing. In case of existing companies, the prospectus has to be signed by every person who is named therein as director of the company or by his agent authorised writing.

Registration of prospectus (Sec. 60):

A prospectus can be issued by or on behalf of a company only when a copy thereof has been delivered to the Registrar for registration. The registration must be made on or before the date of publication thereof. The copy must be signed by every person who is named therein as director or proposed director of the company, or by his agent authorised in writing. Further, such a prospectus must state on the face of it that a copy of it has been delivered to the Registrar for registration on or before the date of its publication.

The prospectus must be issued within 90 days of the date on which a copy thereof is delivered for registration. If a prospectus is not issued within this period, it is deemed to be a prospectus, a copy of which not been delivered to the Registrar.

Penalty for non-registration of prospectus:
If a prospectus is issued without a copy thereof being delivered to the Registrar for registration, or without the necessary documents or the consent of the experts, company and every person, who is knowingly a party to the issue of prospectus, shall be punishable with fine which may extend toRs.50,000.

5.49.2 OBJECTS OF REGISTRATION OF PROSPECTUS

The objects of registration prospectus are:

i. to keep an authenticated record of the terms and conditions of issue of shares or debentures, and

ii. to pinpoint the responsibility of the persons issuing prospectus for statements made by them in the prospectus.

Information memorandum (Sec. 60-B) as inserted by the Companies (Amendment) Act, 2000]

A public company making an issue of securities may circulate information memorandum to the public prior to filing of a prospectus. If the company invites subscription by this information memorandum, it shall be bound to file a prospectus prior to the opening of subscription lists and the offer as a red-herring prospectus, at least 3 days before the opening of the offer. "Red-herring prospectus" means a prospectus which does not have complete particulars on the price of the securities offered and the quantum of securities offered.

Every variation in the information memorandum and the prospectus shall be individually intimated to the persons invited to subscribe to the issue of securities.

5.49.3 CONTENTS OF PROSPECTUS

Prospectus is the window through which an investor can look into the soundness of a company's venture. The investor must, therefore, be given a complete picture of the company's intended activities and its position. This is done through prospectus which must secure the fullest disclosure of all material and essential particulars and lay the same in full view of all intending purchasers of shares.

Matters to be stated and reports to be set out in prospectus (Sec. 56):

Sec. 56 lays down that every prospectus issued

a. by or on behalf of a company

b. by or on behalf of any person engaged or interested in the formation of a company, shall -

i. state the matters specified in Part I of Schedule II, and

ii. set out the reports specified in Part II of Schedule II.

These provisions as stated above shall have effect subject to the provisions contained in Part III of Schedule II.

The revised format of prospectus is given in Schedule II of the Companies Act, 1956. The revised format is effective from 1st November, 1991. The format has been revised to provide for greater disclosure of information regarding the company, its management, the project proposed to be undertaken by the company, the financial performance of the company for the last 5 years and management perception of risk factors so as to enable the investors to take an informed decision regarding investment in shares or debentures offered through public issue.

The important contents of prospectus are as follows:

Part I of Schedule II:

I. General information:

i. Name and address of registered office of the company.
ii. Consent of the Central Government for the present issue and declaration of the Central Government about non-responsibility for financial soundness or correctness of statements.
iii. Names of Regional Stock Exchange and other stock exchanges where application is made for listing of present issue.
iv. Provisions relating to punishment for fictitious applications
v. Declaration about refund of the issue if minimum subscription of 90 per cent is not received within 90 days from closure of the issue.
vi. Declaration about the issue of allotment/refund within a period of 10 weeks.
vii. Date of opening of the issue. Date of closing of the issue. Date of earliest closing of the issue.
viii. Name and address of auditors and lead managers.
ix. Name and address of trustee under debenture trust deed (in case of debenture issue).
x. Rating from CRISIL (Credit Rating Information Services of India Limited) or any rating agency obtained for the proposed debenture/preference share issue. If no rating has been obtained, this fact should be stated.
xi. Underwriting of the issue (Names and addresses of the underwriters and the amount underwritten by them).

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II. Capital structure of the company:

a. Authorised, issued, subscribed and paid-up capital.
b. Size of present issue giving separately reservation for preferential allotment to promoters and others.
c. Paid-up capital:

i. after the present issue,

ii. after conversion of debentures (if applicable).

III. Terms of the present issue.

a. Terms of payments.

b. Rights of the instruments holders.

c. How to apply - availability of forms, prospectus and mode of payment.

d. Any special tax benefits for company and its shareholders.

IV. Particulars of the issue.

a. Objects,

b. Project cost,

c. Means of financing (including contribution of promoters).

V. Company, management and project:

i. History and main objects and present business of the company.

ii. Subsidiary (ies) of the company, if any.

iii. Promoters and their background.

iv. Names, addresses and occupations of manager, managing director and other directors including nominee directors, whole-time directors (giving their directorship in other companies).

v. Location of project.

vi. Plant and machinery, technology process, etc.

vii. Collaboration agreements.

viii. Infrastructure facilities for raw material, water, electricity, etc.

ix. Schedule of implementation of the project and progress so far.

x. Nature of product, approach to marketing and export possibilities.

xi. Future prospects - expected capacity utilisation during the first 3 years from the date of commencement of production, and the expected year when the company would be able to earn cash profits and net profits. Stock market data for share/debentures of the company [high/low price in each of the last 3 years and monthly high/low during the last 6 months (where applicable).

VI. Particulars in regard to the company and other listed companies under the same management which made any capital issue during the last 3 years:

i. Name of the Company.

ii. Year of the issue,

iii. Type of the issue (Public/Rights/Composite),

iv. Amount of issue,

v. Date of closure of issue,

vi. Date of completion of delivery of share/ debenture certificates.

vii. Date of completion of the project, where object of the issue was financing of the project,

viii. Rate of dividend paid.

VII. Outstanding litigation pertaining to-

i. Matters likely to affect operation and finance of the company including disputed tax liabilities of any nature, and criminal prosecution launched against the company and the directors.

ii. Particulars of default, if any, in meeting statutory dues, institutional dues and dues towards debenture-holders fixed depositors.

iii. Any material developments after the date of the latest balance sheet and their likely impact.

VIII. Management perception of risk factors (e.g., sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of pro duds, cost/time over-run, etc.).

Part II of Schedule II

A. General information:

i. Consent of Directors, Auditors, Solicitors/Advocates, Managers to Issue, Registrar of Issue, Bankers to the Company, Bankers to the Issue and Experts.

ii. Experts' opinion obtained, if any.

iii. Change, if any, in directors and auditors during the last 3 years and reasons thereof.

iv. Authority for the issue and details of resolution passed for the issue.

v. Procedure and time schedule for allotment and issue of certificates.

vi. Names and addresses of the Company Secretary, Legal Adviser, Lead Managers, Co-managers, Auditors, Bankers to the company, Bankers to the issue and Brokers to the issue.

B. Financial information:

1. Report by the auditors:

A report by the auditors of the company with respect to

a. its profits and losses (distinguishing items of non-recurring nature) and assets and liabilities; and

b. the rates of dividends paid by the company during the preceding 5 financial years.

If, however, no accounts have been made up in respect of any part of the period of 5 years ending on a date 3 months before the issue of the prospectus, the report shall contain a statement of that fact. If the company has subsidiaries, the report shall, in addition, deal with either the combined profits and losses and assets and liabilities of its subsidiaries or each of the subsidiaries, so far as they concern the members of the company.

2. Reports by the accountants:

a. A report by the accountants (who shall be qualified under the Act for appointment as auditor of a company and who shall be named in the prospectus) on the profits or losses of the business for the preceding 5 financial years, and on the assets and liabilities of the business on a date which shall not be more than 120 days before the date of the issue of the prospectus. This report is required to be given if the proceeds of the issue of the shares or debentures are to be applied directly in the purchase of any business.

b. A similar report on the accounts of a body corporate by an accountant (who shall be named in the prospectus) if the proceeds of the issue are to be applied in the purchase of shares of the body corporate so that that body corporate becomes a subsidiary of the acquiring company.

c. Principal terms of loans and assets charged as security.

C. Statutory and other information

1. Minimum subscription.

2. Expenses of the issue giving separately fees payable to :

   a. Advisers.

   b. Registrars to the issue.

   c. Managers to the issue.

   d. Trustees for the debenture-holders.

3. Underwriting commission and brokerage.
4. Previous issue for cash.
5. Previous public or rights issue, if any (during last 5 years) :
   a. Date of Allotment: Closing Date:
      Date of Refunds: Date of listing on the stock exchange :
   b. If the issue is at premium or discount, the amount thereof.
   c. Premium, if any, on each share which had been issued within the 2 years preceding the date of the prospectus.
6. Commission or brokerage on previous issue.
7. Issue of shares otherwise than for cash.
8. Debentures and redeemable preference shares and other instruments issued by the company outstanding as on the date of prospectus.
9. Option to subscribe.
10. Details of purchase of property : If the company proposes to acquire a business which has been carried on for less than 3 years, the length of time during which the business has been carried on.
11. Details of directors, proposed directors, whole-time directors, their remuneration, appointment and remuneration of managing directors, interests of directors, their borrowing powers and qualification shares.
12. Rights of members regarding voting, dividend, lien on shares and the process for modification of such rights and forfeiture of shares.
13. Restrictions, if any, on transfer and transmission of shares/debentures.
14. Revaluation of assets, if any (during last 5 years).
15. Material contracts and inspection of documents.

Part III of Schedule II - Provisions applying to Parts I and II Schedule II:

1. Every person shall, for the purposes of this Schedule, be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase of any property to be acquired by the company in any case where –
   a. the purchase money is not fully paid at the d the issue of the prospectus ;
   b. the purchase money is to be paid or satisfied, wholly or in part, out of the proceeds of the issue offer subscription by the prospectus ;
   c. the contract depends for its validity or fulfilment on the result of that issue.

2. In the case of a company which has been carrying on business for less than 5 financial years, reference to 5 financial years means reference to that number of financial years for which business has been carried on.

3. Reasonable time and place at which copies of all balance sheets and profit and loss accounts on which the report of the auditors is based, and material contracts and other documents may be inspected.

4. Term 'year' wherever used herein earlier means financial year.

Declaration: That all the relevant provisions of the Companies Act, 1956 and the guidelines issued by the Government have been complied with and no statement made in the prospectus is contrary to the provisions of the Companies Act, 1956 and rules there under.

The prospectus shall be dated and signed by the directors.

Statements by experts (Secs. 57 to 59):

1. Experts to be unconnected with formation or management of company (Sec. 57):

   Where a prospectus includes a statement made by an expert, he shall not be engaged or interested in the formation, promotion or management of the company.

   The expression 'expert' includes an engineer, a valuer, an accountant and any other person whose profession gives authority to a statement made by him.

2. Expert's consent to issue of prospectus containing statement by him (Sec. 58):

   A prospectus including a statement made by an expert shall not be issued, unless:

   a. he has given his written consent to the issue of the prospectus with the statement included in the form and context in which it is included, and

   b. a statement that he has given and has not withdrawn his consent as aforesaid appears in the prospectus.

Sec. 58 lays down a wholesome rule intended to protect intending investors by making the expert a party to the issue of the prospectus and making him liable for untrue statements.

Penalty [Sec. 59 (l)]:

If any prospectus is issued in contravention of Sec. 57 or 58, the company, and every person who is knowingly a party to the issue thereof, shall be punishable with fine which may extend to Rs.50, 000.

Check your progress:49

Discuss the contents of Prospectus.

LESSON-50
DIRECTORS

CONTENTS

5.50.1 Appointment of Directors
5.50.2 Qualification of Directors
5.50.3 Removal of Directors
5.50.4 Duties of Directors
Check your progress: 50
Lesson End Activity

Directors are a body to whom the duty of managing the general affairs of the company is delegated. Sec 2(13) of the Companies Act defines Director as “any person occupying the position of director, by whatever name he may be called”.

A director is a person having control over the direction, conduct and management of the affairs of a company. Only an individual can be appointed as a director. The main reason for appointing individuals is that somebody must be held responsible for the acts of the company so that the failure can be justified.

Number of Directors:

Every public company must have at least 3 directors and every other company must have at least 2 directors. A company may limit the maximum number of directors by mentioning the number in the Articles of Association of the company. For increasing the number up to 12, the company must make changes in the Articles of Association and for increasing beyond that, the Central government’s permission is required.

5.50.1 APPOINTMENT OF DIRECTORS

1. First Directors:
   Articles of Association of the company usually name the First directors by their respective names. If the Articles do not include such details, the subscribers of the Memorandum of Association become the directors of the company.

2. Appointment by the company:
   Directors must be appointed by shareholders in the general meetings. At least $1/3^{rd}$ of the total number of directors must be permanent directors. The others retire by rotation at every general meeting. This is a statutory requirement which cannot be avoided.

3. Appointment by directors:
   In case of a public or a private company which is a subsidiary of a public company, if the office of any director appointed by the company is vacant, the other directors can appoint some individual as a director who shall hold the office till the next general meeting. Causal vacancies may arise due to death, resignation, disqualification or failure of a person to accept directorship.
   Sometimes additional directors may be appointed by the existing directors. The additional directors will hold the post till the next annual general meeting. An alternate director may be appointed to act on behalf of the original director during the original director's absence.

4. Appointment by Central government:
   In order to safeguard the interest of the company/shareholders, the Central government may appoint directors who will hold the post for not more than 3 years.

5. Appointment by third parties:
   $1/3^{rd}$ of the total number of directors may be appointed by third parties like banking/financial institution, debenture holders or creditors of the company. Such appointment must be made once in 3 years and the provision should be provided in the Articles.

6. Appointment by proportionate representation:
   $2/3^{rd}$ of the directors are appointed by a single vote or cumulative votes and appointment is made once in 3 years. This method of appointment ensures that even minority shareholders are given right to vote on the board.

5.50.2 QUALIFICATION OF DIRECTORS

Share qualification refers to a specified number of shares, which a person must hold to qualify himself for appointment as a director. A person willing to be appointed as a director must hold at least 1 share in the company. If a person is appointed without the share qualification, within 2 months of the appointment he should buy the qualifying shares. The nominal value of the shares must not exceed Rs.5,000.

Disqualification of a Director:

Following people are disqualified to act as directors:

i. A person who is insolvent
ii. Person of unsound mind
iii. Person who has applied for insolvency
iv. Person who has been disqualified to act as a director by a court of law.

Number of Directorships:

A person cannot act as director in more than 20 companies at a given time. If he is holding the directorship in more than 20 companies, he is punishable with a fine for each company in excess.

5.50.3 REMOVAL OF DIRECTORS

Directors can be removed by:

1. Shareholders:
   Shareholders may pass an ordinary resolution at the general meeting to remove a director before expiry of the period of his office. Shareholders cannot remove a person from directorship when the appointment is by the Central Government or when the company follows the policy of retiring 2/3rd of directors every year.

2. Central Government:
   Central Government may remove a person from directorship on recommendation of the Company Law Board. This can be done when the director has been fraudulent, negligent or done business against company policies.

3. Company Law Board:
   To prevent mismanagement and oppression, Company Law Board can remove a person from directorship. The person involving in such acts and terminated from directorship for such behaviour cannot sue the company for damages.

5.50.4 DUTIES OF DIRECTORS

Fiduciary Duties:

The directors must exercise their duties and powers honestly and for the purpose for which they are appointed. The director must act in such a way that he avoids a conflict between his personal interest and the interest of the company. All the activities of the director must be beneficial to the company and he should not make any secret profits.

1. Duties of skill, knowledge, care and diligence:
   Directors have to carry out their activities with utmost care. They are expected to exercise high degrees of skills, knowledge, care and diligence while exercising their decisions and powers.

2. Other duties:
   Directors are expected to attend meetings without fail and they should not delegate their functions beyond the authorised limit. They should not disclose any information that will affect the interest of the company.

Check your progress:50

Who are directors?

LESSON-51

COMPANY MEETINGS, RESOLUTIONS AND MINUTES

CONTENTS

5.51.1 Companies Meetings
5.51.2 Requisites of a valid meeting
Check your progress: 51
Lesson End Activity
Let Us Sum Up

5.51.1 COMPANY MEETINGS

The meetings are classified as follows:

I. Members' meetings
a. Statutory Meeting
b. Annual general Meeting (AGM)
c. Extra-ordinary General Meeting
d. Class Meetings of Shareholders

II. Directors' Meetings
a. Board Meeting
b. Committee Meeting

III. Creditors' and Debenture-holders' Meetings
a. Meeting during the life time of the company
b. Meeting at the time of winding up

I. Members' Meetings:

a. Statutory Meeting:

This is the first meeting of the shareholders. This is held once in the life time of the company. Every public limited company, limited by shares and by guarantee, should hold this meeting within a period of not less than 1 month and not more than 6 months from the date of commencement of business. A duly dated and signed copy of the statutory report along with the notice for the meeting must be sent to all the members at least 21 days before the date of the meeting. The main objective of this meeting is:

1. To put the shareholders in possession of all the facts regarding the nature of the company, its incorporation, allotment of shares etc.
2. To enable the shareholders to discuss any of the matters mentioned above
3. To approve any modification in the terms of the contract.

Procedure of the meeting:

When the meeting is commenced, the company secretary must produce a list showing the name and addresses of all the members along with the details of the number of shares held by them. This list is kept open and it is accessible by any member. The members at the meeting have the right to discuss any matter mentioned in the notice but special resolution cannot be passed for matters not mentioned in the notice.

Statutory Report:

It is a report which according to the Companies Act must be forwarded to the members at least 21 days before the meeting.

Contents of the Statutory Report:

i. The total cash received through the subscriptions
ii. The number of shares allotted
iii. An abstract of the receipts and payments
iv. The list of directors and auditors
v. Particulars about the underwriting contract
vi. Details regarding Calls-in-arrears
vii. Percentage of commission and brokerage paid to the intermediaries.

This report must be verified and certified by at least 2 directors of the company.

b. Annual General Meeting:

Every company shall in each year hold in addition to any other meeting, a general meeting as its Annual General Meeting. There shall not be an interval of more than 15 months between one AGM and the other. The company may hold its first AGM within a period of 18 months from the date of incorporation. In that case, the company need not hold the AGM in the year of incorporation. In certain situations, the meeting may be extended by a period not exceeding 3 months. There should be at least one AGM in a year. The notice for an AGM shall be sent at least 14 days before the date of meeting. It is necessary to hold the meeting during the business hours of a working day and not on a public holiday. The meeting may be held at the Registered Office of the company or at some other place in the same city or town where the Registered Office is located. The AGM is a statutory requirement and it has to be called even when there is no operation in the company for the particular year.

When an AGM convened on a particular date has to be cancelled due to certain reasons, the Board of directors can cancel or postpone the holding of the meeting. If a company fails to hold an AGM, any member can apply to the Company Law Board or to the Central Government to call for the meeting. Every director who is responsible and is in default shall be punishable with a fine.
The Central Government interferes in the conduct of the meeting, if the default is made by the company and the matter has been referred to the Government. The fine may extend to Rs.50,000 in case for not conducting the meeting and for continuous default, the officer responsible is punishable with a fine of Rs.2,500, every day till the default continues.

c. Extra-ordinary General Meeting:

A statutory meeting and AGM are called ordinary meetings. Any meeting other than those are called Extra-ordinary Meetings. This meeting is for transacting some special business or some urgent matters which cannot be postponed till the next general meeting. It is convened by the Board of directors or by the members on the failure of the board to call for the meeting. The requisition from the members should be such that it comes from the members who hold $1/10^{th}$ of the paid up capital.

d. Class meeting of shareholders:

When a company has more than one class of shareholders i.e., equity, preference and debenture holders, separate meetings must be convened for each class of the members when any proposals affects the particular type of shareholders. The Articles provides for the conduct of such meetings and a special resolution is passed for bringing about any change in the rights of any class of shareholder.

II. Directors' Meetings:

a. Board Meetings:

The management and the administration of the affairs of the company lies in the hands of the representatives called the directors. The directors meet at regular intervals to decide on the policy matters and review the affairs of the company. The board meeting must be held once in 3 months i.e., at least 4 times in a year. The general business in the meeting include issue of shares, allotment, calls, appointment, promotion and dismissal of the staff, deciding the borrowing power, maintenance of the statutory book etc.

b. Committee Meeting:

The directors delegate their powers to the sub-groups of members to investigate and submit report regarding the matter to the directors. In case the matter is permanent, permanent committee is formed like Works Committee, Shares Transfer Committee etc.

Some committees may be set up for resolving the temporary issues like shares allotment, committee, grievances committee etc.
The committees should meet periodically and investigate into various issues and submit a report to the board.

III. Meetings of Creditors and debenture holders:
This meeting may be held for the purpose of getting support from the company when it goes for reorganisation, reconstruction or amalgamation or at the time of winding up. This meeting helps to discuss the financial difficulties and the ways of overcoming it.

5.51.2 REQUISITES OF A VALID MEETING

1. Proper authority:
   The meeting must be convened only by the board of directors by passing a special resolution. The company's secretary fixes the date in consultation with the chairman. In case, if the directors fail to call for the meeting, then the members may convene a meeting.

2. Notice of the meeting:
   A proper notice should be given to the members. At least 21 days notice must be given before the meeting. The notice is deemed to be received after the expiry of 48 hours after posting the letter. The notice must mention the date, place, time and the matters to be discussed in the meeting

3. Chairman of the meeting:
   A chairman is necessary to conduct the proceedings of the meeting. He will act as the presiding officer of the meeting. The members, who are physically present for the meeting, elect one amongst them as the chairman. He is responsible for the proper conduct of the meeting. He must be aware of the transactions to be discussed in a meeting and also see that all the matters are taken up for discussion. He should maintain discipline and decide on the incidental questions arising from the discussions in a meeting.

4. Minutes of the meeting:
   The secretary must record all the proceedings of the meeting. This record is known as Minutes.

5. Quorum:
   Quorum means minimum number of members who must be present in order to constitute a meeting and transact the business. The Quorum is 5 members for a public company and 2 for any other company.

MINUTES

Whenever a meeting is held, the secretary must record all the proceedings of the meeting. This record is known as Minutes. The minutes will contain in brief all the issues that are discussed during a particular meeting. It has to be signed by all the members who attended that particular meeting. Minutes of the previous meeting should be read at the beginning of a meeting.

RESOLUTIONS

The important decisions taken during a meeting are known as resolutions. Resolutions are also passed for bringing about changes in the existing rules or other issues of an organisation. Resolutions can be either Ordinary Resolutions or Special Resolutions as per the requirements.

Check your progress:51

What are the requisites of a valid meeting?

Lesson End Activities:

Collect copies of Memorandum of Association and Articles of Association and compare them.

Let us sum up:

- Lindley. L.J defines a company as “an association of many persons who contribute money or money’s worth to a common stock, and employ it in some common trade or business, and who share the profit or loss arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share; shares are always transferable although the right to transfer them is often more or less restricted”.
- From the juristic point of view, a company is a legal person distinct from the members who are the shareholders. This principle is known as “Veil of Incorporation” or “Corporate Veil”. The court in general considers itself bound by this principle. The effect of this principle is that, there is a fictitious (imaginary) veil (and not a wall) between the company and its members. It means that the company has a corporate personality which is different from its members.

- A certificate of incorporation given by Registrar to a company is the conclusive evidence that all the requirements of the Companies Act have been satisfactorily met by the promoters.

- A Promoter is a person who does the necessary preliminary work required for the formation of a company. The first persons who control a company's affairs are its promoters.

- 'Ultra' means 'beyond' and 'vires' means 'powers'. The term ultra vires a company means that the doing of the act is beyond the legal power and authority of the company.

- Memorandum of Association is a document of great importance in relation to the proposed company. It contains all the fundamental conditions upon which the company is allowed to be incorporated. It is the "Charter of the Company".

- The Articles of Association or just Articles are the rules, regulations and bye-laws for the internal management of the affairs of a company.

- Every outsider dealing with a company is deemed to have notice of the contents of the Memorandum and the Articles of Association. These documents, on registration with the Registrar, assume the character of public documents. This is known as constructive notice of Memorandum and Articles.

- The doctrine of constructive notice protects the company against outsiders whereas the doctrine of indoor management seeks to protect outsiders against the company.

- Any document inviting deposits from the public or inviting offers from the public for the subscription of shares or debentures of a company is a prospectus.

- Directors are a body to whom the duty of managing the general affairs of the company is delegated.

Reference Books:

1. Elements of Mercantile Law- N.D.Kapoor
2. Mercantile Law- M.C.Shukla